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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1945

No. 93

HERCULES GASOLINE COMPANY, INC.,
PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR CERTIORARI FILED MAY 28, 1945.

CERTIORARI GRANTED OCTOBER 8, 1945.

SUPREME COURT OF THE UNITED STATES

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HERCULES GASOLINE COMPANY, INC.,
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INDEX

JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., OCTOBER 18, 1945.

[fol. a] [Caption omitted]

[fol. 1]

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 11038

HERCULES GASOLINE COMPANY, INC., Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent

DOCKET ENTRIES

Appearahces:

For Taxpayer: Melvin F. Johnson.
For Comm'r: Homer J. Fisher.

1942

May 14—Petition received and filed. Taxpayer notified. Fee paid.
May 15—Copy of petition served on General Counsel.
May 14—Request for Circuit hearing in Shreveport, La., filed by taxpayer. 5/15/42 copy served.
June 24—Answer filed by General Counsel.
June 30—Copy of answer served on taxpayer. (Shreveport, La.)

1943

Oct. 25—Hearing set Dec. 6, 1943—Shreveport, Louisiana.
Dec. 7—Hearing had before Judge Turner on merits. Submitted. Plea of Res Adjudicata and Plea of Unconstitutionality filed. (Appearance of J. H. Jackson, Esq. filed.) Special permission granted for appearance. Application for admission to practice before Court to be filed. Peti-
[fol. 2] tioner's brief due in 45 days—Jan. 21, 1944. Respondent's—30 days—Feb. 21, 1944. Petitioner's reply—15 days—Mar. 6, 1944.

1944

Jan. 17—Motion for extension of 15 days to file brief, filed by taxpayer. 1/17/44 granted.
Jan. 28—Brief filed by taxpayer. 1/29/44 copy served.

1944

Feb. 16—Motion for extension to April 15, 1944 to file respondent's brief filed by General Counsel. 2/18/44 Granted to April 8, 1944.

Feb. 18—Transcript of hearing 12/7/44 filed.

Apr. 8—Brief filed by General Counsel. Served 4/10/44.

Apr. 21—Motion for extension to Apr. 30, 1944 to file reply brief, filed by taxpayer. 4/22/44 Granted.

Apr. 27—Reply brief filed by taxpayer. 4/27/44 copy served.

July 31—Memorandum Findings of fact and opinion rendered. Turner, J. Decision will be entered for the respondent. Copy served.

July 31—Decision entered, Turner, J. Div. 8.

Sept. 28—Petition for review by U. S. Circuit Court of Appeals, Fifth Circuit, with assignments of error filed by taxpayer.

Sept. 28—Praecipe for record filed by taxpayer.

Sept. 29—Proof of service of praecipe for record filed by taxpayer.

Sept. 30—Proof of service of petition for review filed by taxpayer.

Oct. 23—Certified copy of order from Fifth Circuit directing Tax Court to forward a verbatim transcript of the testimony in lieu of a statement of evidence and also exhibits in the original filed.

[fol. 3] BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket Number 111038

HERCULES GASOLINE COMPANY, INC., Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

PETITION—Filed May 14, 1942

The petition of Hercules Gasoline Company, Inc., a Delaware corporation domiciled in Wilmington, Delaware, with respect, represents that it appears herein for the purpose of praying for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of

deficiency dated February 27, 1942, and as a basis for its proceeding alleges as follows:

1

That petitioner is a cosporation organized under the laws of Delaware, domiciled at Wilmington, Delaware, and appearing herein as the transferee of, and successor to, Hercules Gasoline Company, Inc., a Louisiana corporation, domiciled at Shreveport, Louisiana. The return for the period here involved was filed with the Collector of Internal Revenue at New Orleans for the District of Louisiana.

2

The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed to petitioner on February 27, 1942.

[fol. 4]

3

The taxes in controversy are income and excess profits taxes for the taxable years ending December 31, 1937, and December 31, 1938, in the amount of $35,144.73 Income Taxes, and $862.49 Excess Profits Taxes as shown by attached notice of February 27, 1942.

4

The determination of taxes set forth in said notice of deficiency is based upon the following errors:

(a) Failure of the Commissioner to recognize depreciation and abandonment of plant, pipe lines and equipment for the years 1937 and 1938, amounting to $21,092.88 as a deduction from the gross income, under Section 23 of the Revenue Act of 1936;

(b) Disallowance by the Commissioner of credit against undistributed profits taxes for the year 1937 because of a provision in the charter and preferred stock certificates restricting the payment of dividends, as a contract expressly prohibiting payment of dividends under Section 26(c) of the Revenue Act of 1936.

(c) Failure of the Commissioner to allow interest deductions in the amount of $9,844.00 for payments made by the corporation to holders of preferred stock during both taxable years.

(d) The Commissioner erred in computing and assessing excess profits tax for the year 1937 in the amount of $862.49 because of his disallowance of depreciation and abandonment of assets and the interest payments on preferred stock and thus increasing the taxable net income in excess of $16,892.17.

5

The facts upon which petitioner relies as the basis for this proceeding are as follows:

[fol. 5] Error 4(a)

The depreciation and loss on abandonment amounting, for both years, to $21,092.88, represents actual abandonment of obsolete machinery and equipment amounting to $6,890.76 and a reasonable depreciation schedule on petitioner's assets for the years involved amounting to $14,202.12.

6

The commissioner attached to his ninety day letter and notice of deficiency a schedule or computation of depreciation by which he arbitrarily assigned what is denominated "average remaining life" to pipe lines, plant, equipment, etc., and disregarded depreciation allowances claimed by petitioner based upon the nature and character of petitioner's business.

7

Petitioner is engaged in the manufacture of casinghead gasoline; petitioner's plant is located near Kilgore, Texas, and its operations are in the East Texas Oil Field.

8

Casinghead gasoline is extracted by petitioner from gas obtained from the casingheads of producing oil wells and the life of petitioner's plant is dependent upon the volume of gas obtained from the producing oil wells; it is the history of all oil fields that gas ceases to flow in recoverable or commercial quantities long before the oil is exhausted.

9

As the volume of gas decreases from the oil bearing sands it becomes necessary to pump the wells or lift the [fol. 6] oil to the surface by artificial means; thus oil is

pumped or lifted to the surface by other artificial means from a field long after the gas from the mineral bearing sands has been exhausted.

10

Petitioner's plant is located in a section of the East Texas Field where salt water is borne to the surface with the gas and oil and the salt water lessens the volume of gas to petitioner's plant, it gathers in the lines and chokes off the incoming gas and it corrodes and eats holes in petitioner's gathering lines and thus makes it necessary to discard and abandon pipe lines; besides it causes increased hazards of fires and explosions around petitioner's plant.

11

In the East Texas Field in recent years there has been an increase in the number of wells resorting to gas lift as a means of producing their oil allowable; this gas coming up with the oil is dry gas which has been pumped into the formation under pressure and is therefore very lean as to gasoline content and is not desirable for connection with petitioner's plant because there is not sufficient gasoline content in such gas to justify profitable operations.

12

Also, a number of wells in the area being serviced by petitioner's plant are being abandoned as oil wells and therefore abandoned as producers of casinghead gas.

13

A large part of the area served by petitioner's plant is located in the Townsite of Kilgore which is the most densely [fol. 7] drilled section of the entire field, being one well to .73 acres, whereas the average of the field is one well to five acres; consequently this area will be depleted long before other portions of the East Texas Field.

14

Another fact concerning depreciation is this: The majority of pipe in the plant and used throughout the company's gathering and distributing system was secondhand when purchased; in addition, much of the other equipment

in the plant, such as boilers and compressors, were second-hand when purchased; this applies also to numerous pumps, scrubber tanks, valves, etc.; this fact, in connection with the continuous day and night operation of petitioner's plant increases operating wear and tear and shortens the life of petitioner's plant and equipment.

15

There are other equally dangerous hazards to petitioner's business, such as production orders promulgated by the Railroad Commission of Texas and Federal Tender Boards, shutdowns, blackouts, orders permitting wells on the west side of the field to produce 2,000 barrels of salt water along with 20 barrels of oil, the constant operation of petitioner's plant twenty four hours a day and seven days per week,—all of which additional reasons make it appropriate to apply a reasonable and practicable depreciation and abandonment schedule to petitioner's plant and equipment.

16

Petitioner submits that the depreciation computation of the Commissioner is arbitrary, impractical and unreasonable because he has failed to consider the probable useful life of petitioner's plant and equipment.

[fol. 8]

17

Petitioner submits as a reasonable and practicable depreciation basis, considering the nature of its business and its operating conditions, that its plant, pipe lines and equipment have a probable life of not more than about eight years and that a reasonable rate of depreciation would be 15% per year.

18

That, as to abandonment, petitioner claimed abandonment of pipe lines in the amount of $6,654.00 and of obsolete plant equipment in the amount of $5,735.00, making a total abandonment of $12,389.00, which abandonment is supported by the Engineer E. E. DeBack who calculated and detailed the abandoned equipment on the basis of cost, same having been made January 12, 1938, by a written report which has already been submitted to the Technical Staff in connection with the deficiency claimed by defendant.

19

Petitioner has detailed by competent engineers the actual loss and abandonment of $12,389.00 worth of equipment in 1937 and petitioner is prepared to demonstrate upon trial hereof that said equipment was actually discarded and abandoned as entirely useless in petitioner's business and petitioner should be allowed a deduction to the extent shown.

Error 4(b)

20

As to the Commissioner's tax deficiency for undistributed profits, petitioner shows that Hercules Gasoline Company, Inc., (doing business in 1937-8) was incorporated un- [fol. 9] der Act 250 of the Legislature of Louisiana for the year 1928, by articles of incorporation made, signed and accepted according to law on May 10, 1933.

21

Petitioner's charter, Article V, reads as follows:

Article V

"The capital stock of this corporation is hereby fixed at 8,000 shares of no par value common stock and 400 shares of $50.00 par value of preferred stock, which said stock shall be paid for in cash at the time of issuance or for service rendered or property actually received and shall be full-paid and non-assessable.

"The following rights, privileges and conditions shall attach to the shares aforesaid, viz:

"(a) The preferred stock shall be entitled, out of any and all surplus net profits whenever declared by the Board of Directors, to cumulative dividends at the rate of 8% per annum for each and every year from the issuance of such stock, payable semi-annually, in preference and priority to any payment of any dividend on the common stock for such years.

"(b) The Board of Directors shall have the right to redeem any or all of the preferred stock at 102 ($51.00 per share) on any dividend date after giving thirty days written notice to the shareholder, and preferred stock thus redeemed and discharged shall not be reissued.

"(c) The common stock shall be subject to the prior rights of the holders of the preferred stock as above de- [fol. 10] clared and there shall be no dividend on the common stock until all of the preferred stock has been retired, redeemed and discharged.

"(d) Each share of common stock shall be entitled to one vote at all shareholders meeting of the corporation. The holders of preferred stock shall have no voting power whatsoever, nor shall they be entitled to notice of any meeting of stockholders."

22

That a duly constituted meeting of the petitioner's stockholders was held September 16, 1935, the minutes of which were recorded on public records of Caddo Parish, Louisiana, signed and executed in proper written form; that a copy of said proceedings are attached hereto, marked Exhibit B; the stockholders thereby amended Article V of petitioner's charter so as to change Article V only to the extent of providing for 1400 shares of $50.00 par value preferred stock in lieu of 400 shares as originally incorporated; that this article as thus amended and readopted was executed, accepted and filed according to law and approved by the Secretary of the State of Louisiana, as well as by the corporation and the preferred stockholders thereof, on or about September 16, 1935.

(For Petitioner's Exhibit B referred to above, see Original Exhibit 6 introduced in evidence.)

23

That it will be noted that under Article V, subparagraph (c), the corporation made a written contract expressly dealing with the payment of dividends by which it was provided that the corporation would pay no dividend on the common stock until all of the preferred stock had been [fol. 11] retired, redeemed and discharged; that this article and these provisions were expressly referred to on all certificates of stock.

24

That in 1937 and 1938 there was outstanding and due by the corporation preferred stock issued to various creditors amounting to 1294 shares of the par value of $50.00 per share, a total sum of $64,700.00 and therefore under

the stipulation and contract set forth in the charter and expressly referred to in each outstanding preferred stock certificate, petitioner corporation was prohibited from paying any dividends because none of the preferred stock had yet been retired, redeemed or discharged.

25

Petitioner avers that the charter provision above quoted constitutes a written contract executed by the corporation long prior to May 1, 1936, expressly dealing with the payment of dividends and that any attempt of petitioner or its Board of Directors to distribute any of its proceeds as dividends would have violated said contractual obligation.

26

Petitioner further avers that this provision of the charter constituted a written contract binding it to the State of Louisiana, as well as to petitioner's incorporators and to the holders of preferred stock, intended when written to be such, and which was represented to be binding when deliveries of stock were made to the creditors and thus actually constituted an express prohibition against any dividend payment by the corporation or its officers as long as any of petitioner's preferred stock was outstanding and petitioner submits that it should be allowed credit against [fol. 12] surtax on all of its undistributed profits under section 26(c)(1) of the Revenue Act of 1936.

27

Petitioner further alleges and shows that it made many sales and assignments of its preferred stock before May 1, 1936, upon the full faith and obligation, accepted by the creditors, of this charter and certificate provisions and that the holders and owners of the present stock relied upon this provision which was signed by the corporation, its officers, representatives and employees and that said preferred stockholders have never waived or relinquished their rights under this provision.

28

Your petitioner further alleges that the Commissioner of Internal Revenue demanded from Hercules Gasoline Company, Inc., a surtax for undistributed profits for the

taxable year 1936 by his letter of January 24, 1938, and concerning which petitioner filed petition for redetermination in the Board of Tax Appeals September 19, 1938, as will appear by suit entitled Hercules Gasoline Company, Inc., vs. Commissioner of Internal Revenue bearing docket No. 95,530 on the docket of said Court,—to which suit reference now is made.

29

That the same charter and stock certificate provision was concerned in said proceeding; that when the first demand for surtax for the year 1937 was received, by letter from the Commissioner dated February 15, 1939, your petitioner made protest that there should be no surtax on undistributed profits on account of the facts and argument [fol. 13] presented in the pending suit for 1936 taxes above referred to.

30

That the said suit, No. 95,530, never reached trial, but was settled by stipulation signed by counsel for both parties, on or about February 3, 1941, approved and judgment ordered by the Board of Tax Appeals dated February 13, 1941, which settlement constituted an admission by the Commissioner, through his counsel and Technical Staff, that there was no surtax on undistributed profits because of the provisions of the contract with the preferred stockholders which expressly prohibited petitioner from paying any dividends.

31

That the Commissioner of Internal Revenue has already recognized and acknowledged the existence of said dividend restriction, has admitted that because of this prohibition there is no surtax on undistributed profits for the year 1936, and therefore that now he is estopped and should be prevented from claiming any surtax on the same facts and circumstances for the year 1937; that petitioner pleads estoppel against the Commissioner's said tax claim herein.

32

Petitioner further avers that when it negotiated for settlement and then terminated the pending suit for 1936 taxes that it understood that it was settling, and intended to settle and adjust, the claim for surtax for 1937, which

claim he had already made at the time the 1936 suit was settled and which was under discussion and consideration in the settlement and adjustment of the 1936 deficiency; [fol. 14] that the adjustment of tax deficiency for 1936 was consideration for the settlement of 1937 surtax and petitioner is prejudiced by the action of the Commissioner in raising the question again for the later tax based upon the same facts.

33

Your petitioner shows further that the U. S. Circuit Court of Appeal, in a decision rendered March 27, 1942, in suit No. 7852, entitled *Lehigh Structural Steel Company vs. Commissioner*, held that a provision in a preferred stock certificate forbidding the payment of dividends was held to be a contract for which credit should be allowed under section 26(c)(1) of the 1936 Revenue Act.

34

That as disclosed by the balance sheet as of December 31, 1937, the cash on hand was $33,665.29 and the Accounts Receivable were $17,811.38, making the total current assets *$51,476.67*.

35

That the current liabilities as of the same date including Notes Payable, Accounts Payable and Accrued Taxes and Payroll, amounted to $175,971.44; that the mortgage indebtedness amounted to $50,000.00, and the preferred stock debt amounted to $64,700.00 or an additional $114,700.00, which showed the company as owing *$290,671.44*.

36

Therefore, petitioner submits that its financial condition was such that it would have been a breach of trust and unwise, if not impossible, to pay any dividend, stock or cash, [fol. 15] for that year; therefore, the payment of dividends for 1937 would have been impossible, as well as illegal and in violation of the corporate obligation, had it attempted to do so.

37

Petitioner therefore submits on the second assignment of error that for the reasons above given and upon authority of the above decided case, that petitioner should

be allowed credit for all undistributed profits under the law, on account of the positive prohibition above set forth.

Error 4(c)

38

The preferred stock issue as set up and issued in 1933 and 1935 provided for a guaranteed 8% cumulative interest, although the word dividend was inadvertently used to cover interest in the articles of incorporation.

39

That the corporation, as well as the preferred stockholders, understood and considered the guaranteed income on the preferred stock to be 8% per annum interest from date of issue of such stock and the books and accounts of the corporation, as well as the information returns, corporate income tax returns, and the individual income tax returns of the stockholders made account therefor on the basis of interest paid by the corporation and earned by the said creditors.

40

That the minutes of the meetings and the resolutions providing for payment to the preferred stockholders, made at [fol. 16] an unsuspicious time, referred to these disbursements as interest payments; that the letters to the stockholders transmitting the cumulated 8% interest payment directed the stockholders attention to the fact that they were being paid interest.

41

That the accounts of the corporation set up the outstanding preferred stock as a debt and the 8% cumulated payments as interest and earnings were set aside to these ends.

42

That the Department of Internal Revenue has accepted and construed these payments heretofore as interest and allowed them to be deducted from gross income as such.

43

That the holders of preferred stock had no voice or voting power in the affairs of the corporation.

44

That the preferred stock was issued to original parties in 1933, as well as after amendment of the articles of incorporation in 1935, to creditors of the corporation in lieu of and in satisfaction of advances and loans made by them to the corporation and as a matter of fact when issued it was a substitution of one indebtedness for another actual, subsisting debt.

45

That in conclusion on error 4(c), your petitioner submits that the preferred stock constituted a bona fide indebtedness of the corporation and that petitioner should [fol. 17] be allowed to deduct interest paid to preferred stockholders for 1937 and 1938.

Error 4(d)

46

This error of the Commissioner, assigned in paragraph 4 of this petition as 4(d), explains itself.

47

The Commissioner arbitrarily threw out $16,892.17 as unallowable deductions relating to depreciation, abandonment and interest paid to preferred stockholders for the year 1937 and thus increased the taxable net income in the total of $16,892.17, which deductions for reasons stated in the above and foregoing petition, should have been allowed petitioner and when allowed would eliminate this item of the deficiency claimed.

48

Petitioner adopts and accepts the calculation of 2½% paid credit against tax in the computation of income tax liability for 1938 for an amount used to retire indebtedness (page 6 of Commissioner's letter), but this credit should be increased to the sum of $126,670.00 under the provisions of Section 27 of the Revenue Act of 1938.

Wherefore, the petitioner prays that this Board may hear the proceedings and render judgment in favor of petitioner; it further prays that this Board do revoke and set aside the

income tax deficiency claimed by the Commissioner of Internal Revenue by registered letter and deficiency claim under date of February 27, 1942, and that petitioner be [fol. 18] fully relieved and discharged from any further income tax, surtax or undistributed profits or excess profits tax for the years 1937 and 1938; it further prays for all orders neecssary and appropriate and for general and equitable relief.

Hercules Gasoline Company, Inc., by J. Pat Beaird, Vice President.

P. O. Box #764, Cedar Grove Sta., Shreveport, Louisiana.

Melvin F. Johnson, Counsel and Secretary.

1025 Giddens-Lane Building, Shreveport, Louisiana.

Duly sworn to by J. Pat Beaird. Jurat omitted in printing.

[fol. 19] EXHIBIT "A" TO PETITION

(Seal.) Office of Internal Revenue Agent in Charge, Room 517, Federal Office Building, New Orleans Division

Treasury Department,
Internal Revenue Service,
New Orleans, La.

Feb. 27, 1942.

Hercules Gasoline Company, Incorporated (Delaware), 530 Giddens-Lane Building, Shreveport, Louisiana.

Sirs:

You are advised that the determination of the income and excess-profits tax liability of Hercules Gasoline Company, Incorporated (Louisiana), Shreveport, Louisiana, for the taxable years ended December 31, 1937 and 1938, discloses a deficiency of $35,144.73, income tax, and a deficiency of $862.49, excess-profits tax, as shown in the statement attached. The amount of the deficiencies stated, plus interest as provided by law, constituting your liability as a transferee of assets of said Hercules Gasoline Company, Incorporated (Louisiana), will be assessed against you.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal [fol. 20] Revenue Agent in Charge, New Orleans, Louisiana. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully, Guy T. Helvering, Commissioner, by (Signed) William E. Logan, Internal Revenue Agent in Charge.

Enclosures: Statement. Form of waiver. Exhibit A.

JML/lr.

Statement

Hercules Gasoline Company, Incorporated (Louisiana), Transferor

Shreveport, Louisiana

Tax Liability for the Taxable Years Ended December 31, 1937 and 1938

Hercules Gasoline Company, Incorporated (Delaware), Transferee,

Shreveport, Louisiana

Income Tax

Year	Liability	Assessed	Deficiency
1937	$60,169.44	$25,283.46	$34,885.98
1938	31,954.97	31,696.22	258.75
Totals	$92,124.41	$56,979.68	$35,144.73

[fol. 21] Excess-Profits Tax

Year	Liability	Assessed	Deficiency
1937	$2,269.65	$1,407.16	$862.49

The records of this office indicate that the Hercules Gasoline Company, Incorporated (Louisiana), Shreveport, Louisiana, has been dissolved and that assets were transferred to you.

The above-mentioned amounts represent your liability as a transferee of assets of the Hercules Gasoline Company, Incorporated (Louisiana), Shreveport, Louisiana, for deficiencies of income and excess-profits taxes due from the Hercules Gasoline Company, Incorporated (Louisiana), for the taxable years ended December 31, 1937 and 1938.

An analysis of evidence submitted in support of claim for increased depreciation deductions for the years 1937 and 1938, shows that it is based primarily on conditions that developed and events that occurred after 1938. The conditions that have been shown to exist in 1937 and 1938 fail to support a basic life of less than ten years for pipe lines and of 13 years for the refinery, and the deductions for those years have been determined accordingly.

Taxable Year Ended December 31, 1937

Adjustments to Net Income

Net income as disclosed by return		$177,696.86
Unallowable deductions:		
(a) Excessive depreciation	$4,810.82	
(b) Other deductions disallowed	7,385.35	
(c) Interest disallowed	4,696.00	16,892.17
Net income adjusted		$194,589.03

[fol. 22] Explanation of Adjustments

(a) It is held that corporation is entitled to deduction for depreciation in the amount of $50,107.47, as set out in Exhibit A attached, instead of the amount of $54,918.29 claimed on return.

(b) Other deductions claimed on return have been disallowed in the amount of $7,385.35, as set out below.

Loss on abandonment of assets:		
Loss deducted per return		$12,389.00
Loss allowed:		
Basis	$7,854.63	
Less: Depreciation sustained	2,356.39	5,498.24
Loss disallowed		$6,890.76
Amortization of gas contracts:		
Amortization deducted per return	$1,255.51	
Amortization allowed:		
10 percent of $7,609.17	760.92	
Amortization disallowed		494.59
Total other deductions disallowed		$7,385.35

(c) The deduction claimed on return for interest has been decreased in the amount of dividends paid on preferred stock and included therein.

Adjustment to Declared Value of Capital Stock

Value of capital stock as declared in capital stock tax return for year ended June 30, 1937	$1,547,036.69
Increase in net income for normal tax computation for the year ended December 31, 1936	20,577.98
Value as adjusted	$1,567,614.67

[fol. 23] Explanation of Adjustment

Net income for normal tax computation as adjusted	$67,614.67
Net income as disclosed by return	47,036.69
Increase as above	$20,577.98

It is held that preferred stock certificates, which refer to a provision in charter prohibiting the payment of dividends on common stock so long as any of the preferred stock is outstanding, do not constitute a "written contract" within the meaning of section 26(c)(1) of the Revenue Act of 1936. Accordingly, no credit for purposes of determining the undistributed profits tax for 1937 has been

allowed except in the amount of the dividends paid on your preferred stock.

Computation of Tax

Excess-Profits Tax:		
Taxable net income		$194,589.03
Less: 10 percent of $1,567,614.67 adjusted value of capital stock as declared in capital stock tax return for year ended June 30, 1937		156,761.47
Net income subject to excess-profits tax		$37,827.56
5 percent of adjusted declared value of capital stock		78,380.73
Balance		None
Excess-profits tax: 6 percent of $37,827.56		$2,269.65
Total excess-profits tax		$2,269.65
Excess-profits tax assessed:		
Original, account No. 401006		1,407.16
Deficiency of excess-profits tax		$862.49

[fol. 24] *Income Tax:*

Normal Tax:		
Net income for excess-profits computation		$194,589.03
Less: Excess-profits tax		2,269.65
Net income for normal tax computation		$192,319.38
8 percent of $2,000.00 (Over 0 to $2,000.00)		160.00
11 percent of $13,000.00 (Over $2,000 to $15,000.00)		1,430.00
13 percent of $25,000.00 (Over $15,000 to $40,000.00)		3,250.00
15 percent of $152,319.38 (Over $40,000.00)		22,847.91
Total normal tax		$27,687.91
Surtax on Undistributed Profits:		
Net income for excess-profits computation		$194,589.03
Less:		
Excess-profits tax	$2,269.65	
Normal tax	27,687.91	29,957.56
Adjusted net income		$164,631.47

Less:		
Dividends paid credit	$4,696.00	
Credit for contracts restricting dividend payments	None	4,696.00
Undistributed net income		$159,935.47
7 percent of $16,463.15		1,152.42
12 percent of $16,463.15		1,975.58
17 percent of $32,926.29		5,597.47
22 percent of $32,926.29		7,243.78
[fol. 25] 27 percent of $61,156.59		16,512.28
Total surtax		$32,481.53
Total normal tax		27,687.91
Total income tax (normal tax and surtax)		$60,169.44
Income tax assessed:		
Original, account No. 401096		25,283.46
Deficiency of income tax		$34,885.98

Taxable Year Ended December 31, 1938

Adjustments to Net Income

Net income as disclosed by return		$166,822.10
Unallowable deductions:		
(a) Excessive depreciation	$9,391.30	
(b) Interest disallowed	5,148.00	14,539.30
Net income adjusted		$181,361.40

Explanation of Adjustments

(a) It is held that the corporation is entitled to deduction for depreciation in the amount of $55,781.03, as set out in Exhibit A attached, instead of the amount of $65,172.33 claimed on your return.

(b) It is held that the amount of dividends paid on preferred stock and deducted on return as interest, does not constitute interest within the meaning of section 23(b) of the Revenue Act of 1938. Deduction has accordingly been disallowed.

[fol. 26] 2½ percent of dividends paid credit has been allowed as a credit against the tax in the computation of

income tax liability set out below. The dividends paid credit has been determined in accordance with the provisions of section 27 of the Revenue Act of 1938, as follows:

Amount used to retire indebtedness	$95,000.00
Dividends paid on preferred stock	5,148.00
Dividends paid credit	$100,148.00

Computation of Tax

Income Tax:	
Net income for excess-profits computation	$181,361.40
Less: Excess-profits tax	None
Adjusted net income	$181,361.40
Tentative tax, 19 percent	$34,458.67
Less: 2½ percent of $100,148.00 (dividends paid credit)	2,503.70
Balance of tax assessable	$31,954.97
Income tax assessed:	
Original, account No. 400387	31,696.22
Deficiency of income tax	$258.75

(Here follows 1 paster, side folio 27)

[fol. 27]

Hercules Gasoline Company, Incorporated (Delaware), Transferee

Year Acquired	Cost	Abandonments 1936	Abandonments 1937	Balance	Amended Reserve December 31, 1936	Debits to Reserve 1937	Balance to be Depreciated	Average Remaining Life from January 1, 1937	Depreciation Allowed 1937	Depreciation Allowed 1938
Pipe Lines and Meters—Average Life 10 Years—										
1934	$59,044.69	$15,000.00	$7,854.63	$36,190.06	$11,737.28	$2,356.39	$26,809.17	9 Years	$2,978.80	$2,978.80
1935	157,293.30			157,293.30	23,593.99		133,699.31	9 Years	14,855.48	14,855.48
1936	43,481.64			43,481.64	2,174.08		41,307.56	9 Years	4,589.73	4,589.73
1937	20,894.63			20,894.63			20,894.63	8½ Years from July 1/37	1,229.10	2,458.19
1938	70.44			70.44			70.44	7½ Years from July 1/38		4.70
Refineries—Average Life 13 Years—										
1934	96,155.27			96,155.27	23,049.13		73,106.14	12 Years	6,092.18	6,092.18
1935	86,985.96			86,985.96	11,406.93		75,579.03	12 Years	6,298.25	6,298.25
1936	117,435.67			117,435.67	5,431.40		112,004.27	12 Years	9,333.69	9,333.69
1937	71,260.32			71,260.32			71,260.32	11½ Years from July 1/37	3,098.28	6,196.55
1938	24,086.54			24,086.54			24,086.54	10½ Years from July 1/38		1,146.98
Miscellaneous Equipment—Average Life 10 Years—										
1935	1,187.01			1,187.01	237.40		949.61	8½ Years	111.72	111.72
Furniture and Fixtures—Average Life 15 Years—										
1936	1,382.67			1,382.67	69.13		1,313.54	15 Years	87.57	87.57
1937	1,012.67			1,012.67			1,012.67	14½ Years from July 1/37	34.92	69.84
1938	516.83			516.63			516.63	13½ Years from July 1/38		19.13
Automobiles and Trucks—							*Rate*			
1933	200.00				150.00		Balance		50.00	
1934	845.80				616.72		Balance		88.11	
1934	624.00				454.38		Balance		44.62	
1935	1,020.40				485.60		Balance		34.80	
1935	660.00				316.88		25%		165.00	165.00
1935	976.50				484.33		25%		244.13	244.13
1935	248.40				108.66		25%		62.10	62.10
1936	695.00				193.32		25%		173.75	173.75
1935	780.00				211.75		25%		195.00	195.00
1935	271.34				67.83		25%		67.84	67.84
1937	662.50						25% (1937—½ Year)		82.82	165.63
1937	1,235.50						25% (1937—½ Year)		154.44	308.88
1937	207.00						25% (1937—½ Year)		25.88	51.75
1937	11.59						25% (1937—½ Year)		1.45	2.90
1937	62.44						25% (1937—½ Year)		7.81	15.61
1938	685.00						25% (1938—½ Year)			85.63
Total Depreciation Allowed									$50,107.47	$55,781.03

[fol. 28] BEFORE UNITED STATES BOARD OF TAX APPEALS

ANSWER—Filed June 24, 1942

Comes now the Commissioner of Internal Revenue, by his attorney, P. J. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed herein admits and denies as follows:

1, 2, and 3

Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

4 to 32, inclusive

Denies the allegations contained in paragraphs 4 to 32, inclusive, of the petition.

33

Admits the allegations contained in paragraph 33 of the petition.

34 to 48, inclusive

Denies the allegations contained in paragraphs 34 to 48, inclusive, of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore specifically admitted, qualified, or denied.

[fol. 29] Wherefore, it is prayed that the appeal be denied.

(Signed) J. P. Wenchel, HJF, (J. P. Wenchel),
Chief Counsel, Bureau of Internal Revenue.

Of Counsel: James L. Backstrom, Division Counsel, Homer J. Fisher, Special Attorney, Bureau of Internal Revenue.

HJF:mmd. 6/19/42.

IN THE TAX COURT OF THE UNITED STATES

PLEA OF RES ADJUDICATA—Filed at Hearing December 7, 1943

Now comes petitioner, through undersigned counsel, and avers and pleads as follows:

That on or about September 19, 1938, Hercules Gasoline Company, Inc., transferee corporation, filed a petition in

the United States Board of Tax Appeals against the Commissioner of Internal Revenue in proceeding bearing Docket No. 95530, wherein said corporation sought to have revoked and set aside a claim of the Commissioner for income and undistributed profits taxes for the year 1936, as per the Commissioner's letter of June 24, 1938; that said contest involved the same cause of action for undistributed profits tax, based upon identical facts, and was substan-
[fol. 30] tially between the same parties for the same relief, as that set forth in the petition and answer herein; that thereafter, by decision and judgment entered February 13, 1941, there was judgment, pursuant to written stipulation of counsel upon the merits of the case, that there was due no undistributed profits tax for the year 1936 because a contract expressly prohibited the payment of dividends; that no appeal or writ of review is pending from said judgment and that the matters determined in the former action, as well as the same subject matters involved in this suit, are and have become res adjudicata.

Wherefore, your mover prays that this plea of res adjudicata be sustained concerning respondent's claims for surtax for undistributed profits for the year 1937 in this cause; and for orders and decrees necessary and convenient and for general and equitable relief.

Melvin F. Johnson, Attorney for Petitioner.

IN THE TAX COURT OF THE UNITED STATES

PLEA OF UNCONSTITUTIONALITY—Filed at Hearing December 7, 1943

Now comes petitioner, through undersigned counsel, and avers:

That the construction, application and enforcement given to the statute of Congress involved herein by the respondent is contrary to the 5th, 14th and 16th Amendments to the Constitution of the United States, as well as contrary to the provisions of the Louisiana Constitution, particularly Art. 4 Sec. 15 thereof.

[fol. 31] Petitioner pleads unconstitutionality of the statute here in question if it should be interpreted, construed

or enforced as is attempted to be done by the Commissioner of Internal Revenue.

Wherefore, mover prays that this plea of unconstitutionality be sustained and the deficiency assessment annulled and revoked; and for general and equitable relief.

Melvin F. Johnson.

IN THE TAX COURT OF THE UNITED STATES

Transcript of Testimony—Filed February 18, 1944

Hearing at Shreveport, Louisiana.
Date December 7, 1943.

Before the Tax Court of the United States

Docket No. 111038

HERCULES GASOLINE COMPANY, INC., Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Federal Court Room, Shreveport, Louisiana, December 7, 1943, 10:45 o'clock a. m.

(Met pursuant to notice.)

Before Hon. Bolon B. Turner, Judge

APPEARANCES:

Melvin F. Johnson, Esq., 1025 Giddens-Lane Building, Shreveport, Louisiana, and

J. H. Jackson, Esq., 1030 Giddens-Lane Building, Shreveport, Louisiana, appearing for Hercules Gasoline Company, Inc., Petitioner.

Homer J. Fisher, Esq., 1220 Hibernia Building, New Orleans, Louisiana, appearing for Commissioner of Internal Revenue, the Respondent.

[fol. 32] PROCEEDINGS

The Clerk: Docket No. 111038, Hercules Gasoline Company, Inc. State your appearances.

Mr. Johnson: Melvin F. Johnson for the Petitioner. I want to introduce, may it please the Court, Mr. Joseph H.

Jackson to be associated with me. Mr. Jackson is an attorney here in Shreveport.

The Court: Has Mr. Jackson been admitted to practice before this Court?

Mr. Jackson: This is my first appearance, Your Honor. I have been admitted to practice before the Circuit Court of Appeals and the United States Supreme Court, but I have never tried a case before this Court.

The Court: I will permit you to enter your appearance in this case, and the Clerk will have the proper forms mailed to you which you should fill out and send in immediately so that you may be enrolled to practice before this Court.

Mr. Fisher: Homer J. Fisher appearing for the Respondent.

The Court: All right, Mr. Johnson, what is the case about?

Mr. Johnson: This is a case which involves the undistributed profits, or surtax on undistributed profits levied [fol. 33] by Congress in 1936, Section 14 of the Act of that year levying the tax and Section 26 giving credits, and Section 26 C-1, which states that corporations with written contracts which would have to be violated in order to pay dividends, if those contracts are dated before May 1, 1936 they shall be given credit for that contract prohibition. Your Honor is familiar with that Section, no doubt, and with the cases that have attempted to interpret and construe these two Sections.

In our case our present corporation, which is the one involved, Hercules Gasoline Company, Inc., a Louisiana corporation, it was organized under the laws of Louisiana in 1933. Article V of the charter specifies the rights of the common and preferred stockholders.

In 1935 the Articles of Incorporation were amended by the amendment of Article V of the charter, but the only thing, the only change that was made, was to increase the authorized issue of preferred stock from four hundred shares of fifty dollars par to fourteen hundred shares of fifty dollars par. The same number of no par preferred stock, eight thousand shares, was left the same, and the Section of Article V referring to what the rights and privileges of the two classes of stockholders were was left entirely the same.

The Section which we will submit is putting it beyond our power to pay dividends in this Section of our Articles of Incorporation:

"The common stock shall be subject to the prior rights of the holders of preferred stock as above distinguished, and there shall be no dividend on common stock until all of the preferred stock has been retired, redeemed and discharged."

We expect to develop that in 1937, which is the year involved here, we had outstanding twelve hundred and [fol. 34] ninety-four shares of preferred, the total being sixty-four thousand seven hundred dollars.

There is another issue that is involved which relates to the first issue, and that is whether payments to the preferred stockholders are dividends or interest. The petitioner claims that in the charter the word "dividend" was used, but that in the intentment of the parties in the issue of the preferred stock that it was considered interest on the books and with the so-called preferred stockholders, and in all respects it was carried and considered to be interest.

The petitioner also alleges on two other counts, one being on the depreciation schedule, but that is no longer at issue in the case because we are abandoning our claims on depreciation for the year 1937, so that the issues are mainly legal ones as to whether our preferred stock issue was or was not a contract within the intentment of Congress, and the question of interest versus dividends on that same issue of preferred stock.

Mr. Fisher: I have nothing to add to what Mr. Johnson has stated.

I think this would be the proper time to enter into a stipulation that we have made, and that is with reference to the transferee liability of this taxpayer for any assessment which may be determined against this transferee. Mr. Johnson, I think, is willing to stipulate the transferee liability.

Mr. Johnson: Yes, sir, we think the entire liability if any, may be properly claimed against us. The Hercules Gasoline Company of Louisiana was dissolved according to law in 1939. Immediately upon its dissolution the Hercules Gasoline Company, Inc., was organized under the Delaware

laws. We are the successor to and transferee of the Louisiana corporation of the same name.

[fol. 35] The Court: So the question involved here is rather one for trial as to whether or not there was any tax owed?

Mr. Johnson: Yes, Your Honor, that is correct. There is no dispute on the other matters.

The Court: You may proceed, Mr. Johnson.

Mr. Johnson: In the petition we set up facts concerning settlement of the identical issues with the Commissioner in a prior suit before the Board of Tax Appeals No. 95530. In my petition I pleaded estoppel, but I set up all of the facts, and I would like at this time to file a plea of res adjudicata based upon the same facts.

The Court: Let the plea be filed.

Mr. Johnson: May it please the Court, I would like at this time now to file a plea of unconstitutionality, the position of the petitioner being that as the law enacted by Congress is not objectionable on that ground, petitioner feels that the construction attempted to be given the words and laws of Congress would be unconstitutional.

The Court: I don't think I understand you.

Mr. Johnson: Your Honor recalls numerous cases involving interpretation of Section 26 C-1 of the Revenue Act and——

[fol. 36] The Court: I recall some of them; I do not think I could recall all of them.

Mr. Johnson: Well, I would like to file a plea of unconstitutionality so as to raise the issue in this Court that if the construction and application and enforcement of the statute of Congress is to be taken according to the claims of the Commissioner then we say that it is unconstitutional.

The Court: That is a novel element to me, I must confess.

Mr. Johnson: Do you have any objection to my filing it?

The Court: Yes, it may be filed. I will be glad to know what it is, and besides that, this being novel to me, maybe I shall learn something that I didn't know before.

Mr. Johnson: Your Honor is aware that a law can be unconstitutional in its application. I think the construction and application of an Act of Congress can be unconstitutional just as well as a law itself can be unconstitutional. There are cases holding that a law may be constitutional in itself but can be unconstitutional in the application at-

tempted to be given it by those administering it. That is the point that we wish to make here.

The Court: That sounds to me, regardless of what you call it, that although this is a statute of Congress which is proper and which is not unconstitutional itself, but is not being correctly construed, and is being erroneously construed and [fol. 37] applied by the administrative officers, and whether you call it that, or whether you call it unconstitutional application, you arrive at the same place. I think the constitution does not contemplate an administrative officer going beyond the scope and powers granted to him in the constitution, and such officers cannot apply a law contrary to the way Congress enacts it. They are not permitted, at least knowingly, to elucidate or change a law that is enacted by Congress. But I will hear what you have to say in that connection. I will listen to you. You may proceed.

Mr. Johnson: I would like to say to the Court——

The Court (Interrupting): I think, for instance, that we have to follow the regulations issued within the body of the law. Congress authorizes the Commissioner of Internal Revenue to issue regulations for the purpose of administering the Act. Such rules and regulations are to be used as a guide to the administrative officers, and to the taxpayers themselves, and cannot be written literally into the statute. I think it fairly well established that such regulations when promulgated by the Commissioner, and when within the reasonable intentment of Congress as expressed in the statute, are given the force and effect of law, but when an interpretation, or regulation should be issued that is unreasonable and shows on its face that it is against the intentment of Congress as expressed in the statute, then it has no force or effect at all. Of course there is a great difference of opinion at times upon the question of whether or not a given regulation is within the intentment of Congress as expressed in the statute. But you may go ahead.

[fol. 38] Mr. Johnson: Petitioner offers in evidence charter of Hercules Gasoline Company, Inc., to which is attached an amendment of the charter in 1935. This is the same one you have seen, Mr. Fisher. Have you any objection?

Mr. Fisher: I have no objection to the document. I assume there will be some testimony that it was formally filed with the Secretary of State?

Mr. Johnson: Yes, sir.

The Court: The document will be received in evidence as Petitioner's Exhibit No. 1.

(Charter and amendment thereto of Hercules Gasoline Company, Inc., marked Petitioner's Exhibit 1, was received in evidence.)

Mr. Johnson: Petitioner next offers in evidence certificate from the Honorable H. S. Comish, Assistant Secretary of State of the State of Louisiana, which certificate includes the certificate of incorporation, certificate of amendment to the charter; certificate of redemption of outstanding preferred stock; certificate of notice of dissolution; and certificate of final dissolution.

Do you have any objection to that, as Petitioner's Exhibit No. 2?

Mr. Fisher: If Your Honor pleases, the Respondent will have no objection to the authenticity of any of these docu-[fol. 39] ments. The Respondent will object to the third document, the certificate of redemption of outstanding preferred stock under date of May 25, 1939, and also the certificate of final dissolution later on, because of the contents wherein they attempt to show that certain payments were made along with the redemption as interest rather than dividends, which is the question to be determined by the Court in this case.

Mr. Johnson: I think that goes to the effect of the testimony and not to its admissibility. These are under the signature of the office of the Secretary of State, and are admissible on their face.

The Court: The objection will be overruled, and the documents received in evidence as Petitioner's Exhibit 2.

(Certificate of Secretary of State, marked Petitioner's Exhibit 2, was received in evidence.)

Mr. Johnson: Petitioner next offers in evidence preferred stock certificate No. 9 issued to L. J. Dales, this being photostat copy. Do you object to that being received as a true copy of the original certificate?

Mr. Fisher: Subject to a check against the stock book, which I haven't had an opportunity to examine yet. Otherwise, there is no objection.

The Court: Do you offer that one certificate? In other words, do you offer a group of those, or are you offering them one by one?

[fol. 40] Mr. Johnson: I was wondering whether to give them separate numbers. Counsel for the Commissioner stated that he would like to have several certificates that were issued before and after the amendment filed in evidence.

The Court: Let them be filed separately then.

(Stock certificate No. 9 issued to L. J. Dales, marked Petitioner's Exhibit 3, was received in evidence.)

Mr. Johnson: Petitioner further offers in evidence stock certificate No. 6 issued to Melvin F. Johnson for forty shares as Petitioner's Exhibit 4.

Mr. Fisher: No objection.

The Court: The document so offered will be received in evidence as Petitioner's Exhibit 4.

(Stock certificate No. 6 issued to Melvin F. Johnson for forty shares, marked Petitioner's Exhibit 4, was received in evidence.)

Mr. Johnson: Petitioner next offers in evidence stock certificate No. 27 issued to Allendale Heights Company, Inc., on the fifth of October, 1935, for one hundred shares.

Mr. Fisher: No objection.

[fol. 41] Mr. Johnson: That will be identified as Petitioner's Exhibit 5.

The Court: The document in question will be received in evidence as Petitioner's Exhibit 5.

(Stock certificate No. 27 issued to Allendale Heights Company, Inc., for one hundred shares, marked Petitioner's Exhibit 5, was received in evidence.)

Mr. Johnson: Petitioner next offers in evidence certified copy of the minutes of the transferee corporation of date September 16, 1935.

Mr. Fisher: No objection.

The Court: It will be received in evidence as Petitioner's Exhibit 6.

(Certified copy of minutes of transferee corporation dated September 16, 1935, marked Petitioner's Exhibit 6, was received in evidence.)

Mr. Johnson: Petitioner next offers in evidence extract from the minutes of date December 30, 1936.

Mr. Fisher: There is no objection on the ground of the authenticity of this document as being a true copy of the minutes of the Hercules Gasoline Company, Inc. There is an objection that goes to the admissibility of the document otherwise because it refers in the document to certain [fol. 42] stock as eight per cent cumulated interest, and of course the objection is that we cannot go outside of the charter and the stock certificates themselves. They are unambiguous, and need no outside explanations.

The Court: That goes to the question of the weight of the evidence, and not to its admissibility. Of course the document itself cannot change what effect the stock certificates might have, but that will be a matter for determination later. The document will be received in evidence as Petitioner's Exhibit 7.

(Extract from minutes dated December 30, 1936, marked Petitioner's Exhibit 7, was received in evidence.)

Mr. Johnson: Petitioner next offers in evidence extract from the minutes of December 7, 1937.

Mr. Fisher: No objection is made to the authenticity or otherwise except for the reason urged to the receipt of the last exhibit in evidence.

The Court: The objection will be overruled and the document received as Petitioner's Exhibit 8.

(Extract from minutes of December 7, 1937, marked Petitioner's Exhibit 8, was received in evidence.)

Mr. Johnson: I next offer in evidence extract from the minutes of January 5, 1939.

[fol. 43] Mr. Fisher: No objection, with the same qualification as to the two preceding exhibits.

The Court: The document in question will be received in evidence as Petitioner's Exhibit 9.

(Extract of minutes of January 5, 1939, marked Petitioner's Exhibit 9, was received in evidence.)

Mr. Johnson: Petitioner next offers in evidence certified copy of the minutes of May 13, 1939.

Mr. Fisher: While we have no objection as to the authenticity of this document, it is immaterial, I think, being in the year 1939, and reciting redemption of the preferred stock, and reciting that that redemption shall be accompanied by cumulative interest at eight per cent, and

being after the taxable years, 1937 and 1938, it is immaterial on any ground.

The Court: The objection will be overruled and the document admitted in evidence as Petitioner's Exhibit 10.

(Certified copy of minutes of May 13, 1939, marked Petitioner's Exhibit 10, was received in evidence.)

Mr. Johnson: Your Honor, I would like to get before this Court, and into the record, Act 250 of Louisiana of the year 1928, particularly Section 14 of that Act. This is the general corporation Act which is the uniform law of this state, and I have particular reference to Section 14. I do not [fol. 44] know whether it would suit the convenience of the Court to file an extract from that Act, or whether the Court would consider the Act without such filing.

The Court: We can take judicial notice of all Acts of the various states and the United States, and all you need do is to refer to it in your brief or argument if it is of importance.

Mr. Johnson: We will do that then, may it please the Court. We would now like to call our first witness.

The Court: Whatever the Act may be, if it is an Act of the State of Louisiana, we take judicial notice of it. You do not have to prove it.

We will take a brief intermission, Gentlemen.

After Intermission.

Byron A. Irwin, a witness on behalf of the Petitioner, was duly sworn and testified as follows:

The Clerk: State your name for the record, please.

The Witness: Byron A. Irwin.

Direct examination.

By Mr. Johnson:

Q. What is your occupation or profession?

A. Practicing attorney.

[fol. 45] Q. Were you practicing law in 1933?

A. Yes, sir.

Q. And have been continuously up to date?

A. Yes, sir.

Q. Did you purchase any of this so-called preferred stock from Hercules Gasoline Company?

A. Yes.

Q. Do you recall when you did that?

A. I can't recall the exact date, but it seems to me it must have been in the fall around the month of September, 1933.

Q. Under what circumstances did you buy that preferred stock?

A. Well, the president of the company was a very good, close and personal friend of mine, and had been for some time, as well as a client, and he approached me on the subject of taking some of this preferred stock in his company both for myself and my mother.

Q. Did you investigate the charter of the company before doing that?

A. I do not think I investigated the charter because I had such confidence in him I did not consider it necessary. I acted on his representation about the charter provisions.

Q. What were the features of that stock?

A. Well, that they would pay the money back invested in the stock of the company for preferred stock with eight per cent cumulative interest. I was assured by him that the investment on the shares of stock, or the use of the money for that purpose, was entirely safe.

Q. Was any representation made to you there that there would be no dividends to the stockholders until that preferred issue was entirely retired?

A. There was.

Q. Do you know if that representation was carried out with reference to that purchase?

[fol. 46] A. Yes, the whole amount advanced to the company, plus eight per cent per year, was returned in full.

Q. Did you receive cumulative eight per cent interest?

A. Yes, sir.

Mr. Johnson: I tender the witness.

Cross-examination.

By Mr. Fisher:

Q. Did the president of the corporation say to you whether or not this eight per cent would be paid irrespective of whether the corporation had any earnings or not?

A. He said that it would be paid before they would permit any declaration of any dividends.

Q. It would be payable prior to the payment of any dividends on the common stock?

A. Yes.

Q. That is the substance of his representation to you?

A. That is correct.

Mr. Fisher: No further questions.

C. W. Wierick, a witness on behalf of the Petitioner, was duly sworn and testified as follows:

The Clerk: State your full name for the record, please.

The Witness: C. W. Wierick.

Direct examination.

By Mr. Johnson:

Q. Mr. Wierick, you are a resident of Shreveport?

A. Yes, sir.

[fol. 47] Q. How long have you lived here?

A. Since 1916.

Q. What is your occupation.

A. Credit manager at the J. B. Beaird Company.

Q. Is that a plant out near the edge of town here?

A. Yes, sir.

Q. Were you with that company or its predecessors in 1933?

A. Yes, sir.

Q. And have been to date?

A. Yes, sir, to date.

Q. You have been there constantly?

A. Constantly, yes.

Q. Did you acquire any of this preferred stock issue of the Hercules Gasoline Company?

A. Yes, I did.

Q. How much did you acquire?

A. Ten shares in 1933.

Q. That was five hundred dollars?

A. Five hundred dollars, yes, sir.

Q. Did you pay par for that preferred stock?

A. Yes.

Q. So that was five hundred dollars for ten shares, or fifty dollars par, is that correct?

A. That is correct, sir.

Q. Did you buy that on the strength of certain representation as to the characteristics of that purchase?

A. Yes, I did. It was——

Mr. Fisher (Interrupting): I object to this line of testimony for the reason it goes to the point of the rights and obligations of the corporation under the stock which was issued, and I think the preferred stock certificates are completely unambiguous as to what those rights are; therefore, the evidence is incompetent, irrelevant and immaterial.

[fol. 48] Mr. Johnson: If Your Honor pleases, I think that not only what the stock certificates and the charter stated but what was actually done is very important. I think that this Court, and the Circuit Court, will want to know what was said and done back there in regard to what we claim is the contract and what the Commissioner says was in the contract. I can recall a number of cases where the intentions of the parties, and the actions of the parties, has had a definite bearing in that regard, if Your Honor pleases, as to how the Court will construe the cold words in the charter and the preferred stock certificates. Now, we do not want to give the impression that we had articles of incorporation and preferred stock certificates saying such and such. We want to give these contracts life, and show that they were used and relied upon, and, if Your Honor pleases, I think that this testimony is not only material but that it is very important when it is used in connection with the construction of what the Commissioner claims is a doubtful question of a contract or no contract. We want to throw all the light on the subject that we can. We would like to have the Court likewise see as many of the facts surrounding the terms in the Articles of Incorporation as possible.

The Court: Of course I have not had the opportunity, and I am not going to take the time here, to examine and study the articles or the provisions or terms of the stock certificates themselves, but before passing on the question I would like to inquire and ask you whether or not you would take the position that the officers of the corporation had the power and authority to go beyond the provisions and requirements of your Articles of Incorporation?

Mr. Johnson: No, sir, they could not do that.

[fol. 49] The Court: Or that the terms of the contracts were not properly followed as shown in these stock certificates. I understand that there has been some argument over the proposition as to whether the stock certificates constitute a contract within the meaning of Section 26, but you would not take the position, I take it, that the officers did go beyond the reasonable terms of the stock certificates as expressed therein, and the provisions of the Articles of Incorporation as shown therein, but as I understand you, you are showing here representations that were made in connection with the issuance of the certificates under your Articles of Incorporation.

Mr. Johnson: Yes, sir.

The Court: The objection will be overruled.

Mr. Fisher: I object further on the ground the crucial question is the written contract, and that the proof of that would be the terms of the contract, the written contract, and the charter itself.

The Court: There are two questions here: You have a written contract, and you desire to offer proof on that, which you have done, and you have another question of whether or not interest was paid or dividends were paid, and I take it that this examination here is as to whether or not it was one or the other, in other words we have the question of dividends versus interest.

Mr. Johnson: It is directed to both of them. They are both tied in.

[fol. 50] The Court: The objection will be overruled.

Mr. Johnson: Read the question.

(Whereupon the reporter read the last question as herein before recorded.)

Q. Answer the question.

The Court: I think he did. He answered the question I think by stating there were representations.

By Mr. Johnson:

Q. What were the representations that were made at that time?

A. It was represented to me that they would pay eight per cent interest, cumulative interest, and that no other stock obligations of the company would be paid until that was paid off in full.

Q. Was that the action of the company following your purchase?

A. Yes, it was.

The Court: Let me get that straight; you mean the action of your company?

The Witness: The action of the Hercules Gasoline Company.

By Mr. Johnson:

Q. Was this representation of eight per cent cumulative interest and deferment of any question of dividends until [fol. 51] it was all retired carried out by the Hercules Gasoline Company, in your case?

A. Yes, it was.

Mr. Fisher: That is objected to as calling for a conclusion on the part of the witness, and he is not an officer of the company who made these representations.

The Court: I think in that respect, Mr. Johnson, you would have to show that this witness could testify on that point. That would be a matter that should be shown by some officer of the company, or the company's records, I take it. On objection I think you would have to show this witness could testify. He can testify he got his money.

Mr. Johnson: I think you are correct undoubtedly.

The Court: But he would not know whether or not it was paid before anything was paid on the common stock.

By Mr. Johnson:

Q. Did you receive eight per cent cumulative interest on your purchase of that preferred stock?

Mr. Fisher: That is objected to as calling for a conclusion on the part of the witness as to whether it was interest or dividend.

By Mr. Johnson:

Q. Did you receive payment of eight per cent per annum from the date you bought it?

A. Yes, sir, I did.

[fol. 52] Q. Do you recall when your preferred stock certificate was retired or redeemed?

A. I believed it was retired in 1939.

Q. Did you pay tax on it and list it as income in your return in 1936, giving the amount of these payments as interest earned?

A. Yes, sir, I did.

Mr. Fisher: That is objected to as being immaterial.

The Court: Objection overruled.

By Mr. Johnson:

Q. Did you make the same showing in your 1937 personal income tax return of interest earned and received from the Hercules Gasoline Company?

Mr. Fisher: Same objection.

The Court: Overruled.

The Witness: Yes, sir.

By Mr. Johnson:

Q. In 1939 when you say it was retired did you receive eight per cent calculated down to the date that your five hundred dollar fund was repaid to you?

Mr. Fisher: That is objected to as something occurring after the taxable year.

[fol. 53] The Court: Objection overruled.

The Witness: Yes, sir, I did.

By Mr. Johnson:

Q. Mr. Wierick, I have a letter from the Hercules Gasoline Company, Inc., dated December 30, 1936, which I will mark Petitioner's Exhibit 11 for identification, and I will ask you if that is your signature down in the lower left hand corner of it?

A. Yes, sir, that is my signature.

Mr. Fisher: I will admit that that is a true copy of a letter written by the witness on the date indicated, but I object to the materiality of the letter.

Mr. Johnson: I haven't offered it yet, but I do offer it now, the offering consisting of the letter just referred to dated December 30, 1936, just identified by the witness.

The Court: The objection will be overruled, and the document will be received in evidence as Petitioner's Exhibit 11.

(Letter dated December 30, 1936, marked Petitioner's Exhibit 11, was received in evidence.)

By Mr. Johnson:

Q. I believe you have already testified, Mr. Wierick, that you received eight per cent on your preferred certificate also in the year 1937?

A. Yes, sir.

[fol. 54] Q. I show you a copy of a letter dated December 23, 1937, and will ask you if you received the original of that letter?

A. Yes, sir, I did.

Mr. Johnson: I offer in evidence the letter just identified by the witness, dated December 23, 1937, and marked Petitioner's Exhibit 12 for identification.

Mr. Fisher: That letter is objected to as being immaterial.

The Court: Objection overruled, and the letter will be received in evidence marked Petitioner's Exhibit 12.

(The letter dated December 23, 1937, marked Petitioner's Exhibit 12, was received in evidence.)

Mr. Johnson: Witness tendered.

Cross-examination.

By Mr. Fisher:

Q. Mr. Wierick, when you bought this stock were any representations made to you in writing about your rights under the stock?

A. No, sir, none other than what Mr. Beaird told me.

Q. Who was Mr. Beaird, Mr. Weirick?

A. Mr. Beaird was an officer of the Hercules Gasoline Company and a good friend of mine.

Q. Was he one of the principal stockholders of the Hercules Gasoline Company?

A. Yes, sir, he was.

[fol. 55] Q. Was he also one of the principal stockholders of The J. B. Beaird Company by whom you were employed?

A. Yes, sir, he was.

Q. Would it have made any difference to you in determining whether you would invest in this stock as to whether Mr. Beaird called the amount of eight per cent you were to receive dividends or interest?

A. Well, I believe it would have. He told me that the interest on the stock would be paid before any other obliga-

tion of the company would be paid, and I figured it would be a preferred debt.

Q. Well, was your interest chiefly in having eight per cent paid to you before any dividends were paid on the common stock?

A. Yes, sir, I was interested in receiving my interest before any dividends were paid.

Q. Now, you did not care whether they called it interest or dividends when they paid it to you, did you?

A. Well, they had called it interest all the time; they said there would be no dividends paid until that stock and interest was paid.

Q. They said there would be no dividends paid or recommended before your eight per cent was paid, isn't that what they said?

A. Yes, sir, they said there would be no dividends paid by the company until the principal and interest on the stock that I bought in the company was paid.

Q. They did not tell you of any particular date on which your principal investment would be returned to you?

A. No, sir, they did not. At that time that was not a factor. They started from scratch, and they could not tell when any money would be paid.

Q. As a business man, Mr. Wierick, when you buy stock don't you expect the return you get on that stock to be dividends?

A. Not in this case, no, sir.

[fol. 56] Q. But generally speaking when you buy stock don't you expect dividends to be paid on it?

A. I do not make a practice of buying stock. I don't know.

Mr. Fisher: That is all.

Redirect examination.

By Mr. Johnson:

Q. You made the statement that there was nothing in writing about the representations that were made to you; I will ask you if you received any of these certificates such as have been offered here today?

A. Yes, that was the only information I had in writing. However, I took Mr. Beaird's word for it.

Q. But Mr. Beaird's word was confirmed by the written certificate?

A. Yes.

Q. What you mean is that it was not necessary for you to have anything in writing?

A. That is correct. It was not necessary.

Mr. Johnson: That is all.

Recross-examination.

By Mr. Fisher:

Q. Mr. Beaird did not state to you that these payments would be made to you of eight per cent regardless of whether there were any earnings of the corporation or not, did he?

A. No, sir, he did not say that.

Q. I will ask you to look at a stock certificate, a copy of which has been filed in evidence, and see if you can [fol. 57] find anything on the certificate that refers to interest to be paid thereon?

A. I don't see any on here, no, sir.

Q. So when you received your certificate was your certificate, as well as you remember, like the one I have just shown you?

A. Yes, sir.

Q. You then had before you nothing in writing to confirm anything that Mr. Beaird told you, or any terminology that Mr. Beaird may have used in talking to you and telling you what your payments would be?

A. No, sir.

Mr. Fisher: That is all.

Mr. Johnson: That is all. I will ask to be sworn, please.

Melvin F. Johnson, a witness on behalf of the Petitioner, being duly sworn, testified as follows:

The Witness: If Your Honor pleases, I was the attorney who drew the charter for this corporation, and I propose to testify about it. Does counsel think that I should go ahead and make a statement, or would he prefer to have Mr. Jackson interrogate me?

Mr. Fisher: Whatever procedure you desire to follow, whether you ask yourself questions, or have your associate counsel to question you, I do prefer questions and answers rather than a narrative.

[fol. 58] Direct examination.

By Mr. Jackson:

Q. Mr. Johnson, are you a member of the Shreveport Bar?

A. I am.

Q. You have been practicing law in Louisiana how long?

A. Since 1915, with the interruption of the war.

Q. Have you ever been admitted to practice in any other state except Louisiana?

A. No.

Q. Did you, as an attorney, draw the original charter of the Hercules Gasoline Company, Inc., and the amendment thereto?

A. I did.

Q. The incorporators employed you for that purpose?

A. Yes.

Q. Did you put in the incorporating provisions of the charter under the instructions of the parties who were incorporating the company?

A. Yes.

Q. What instructions, if any, did they give you as to the nature, characteristics and the kind of stock they wanted provided for?

A. They wanted two issues of stock. I drew the provisions to meet what I considered their specifications in that Article V of the original charter in 1933. They wanted preferred stock to issue to get money for the corporation to build up and acquire machinery and other necessary things with the charter itself providing that all of that stock would carry a guaranteed return of eight per cent, and that it would be fully retired and redeemed and not re-issued before there would be any dividends paid to the common stockholders, or on the common stock, and a provision as to no voting power in the preferred stock, and no notice of stockholders meetings to the holders of pre-
[fol. 59] ferred. The word "dividend" was used inadvertently, as I have stated in my petition, but the intention was it would be a guaranteed eight per cent cumulative return to the holders of that class of stock.

Q. With no voice in the management or control of the corporation?

A. That is correct.

Q. You have acted as an officer of the corporation practically since it was organized?

A. Yes, sir.

Q. And you know whether or not these provisions that you have just detailed were thus regarded by the officers of the corporation?

A. Very emphatically. I thought we had put it beyond our power to pay any dividends on the common stock until all of that preferred issue was retired in full.

Q. Do you have anything else that you desire to add there?

A. No, not right now. Perhaps Mr. Fisher has something to ask me.

Mr. Jackson: You may cross examine the witness.

Cross-examination.

By Mr. Fisher:

Q. You have been a practicing attorney here since about 1915, Mr. Johnson?

A. Yes, sir.

Q. During that period of your practice from the time you began until 1933, when you prepared the charter of the Hercules Gasoline Company, I assume you incorporated a number of corporations, did you not?

A. Yes, sir.

Q. You knew how to provide in the charter for the issuance of bonds or notes, did you not?

[fol. 60] A. I do not believe I know just what you mean. Providing for bonds or notes in the charter?

Q. Yes. You knew how to prepare a charter provision providing for the issuance of bonds or notes by the corporation?

A. I will say this: I have never done it. I presume I could put them in there, but the average charter that I have had in Louisiana has been one carrying with it voting stock and other provisions to carry out the objects of the corporation. I have never put such things as you mention in a charter, but I would say I could do it with proper study.

Q. You did know in 1933, of course, when the charter of this corporation was prepared by you the difference between bonds and preferred stock, and between notes and preferred stock, did you not?

A. I would say yes I knew it then, but I have learned a lot more about it since about 1941 or 1942 when this question came up before me.

Q. You also knew from 1933 on how to amend a charter if the corcpration desired to change its financial structure, did you not?

A. Yes, sir.

Q. Now, as the charter was drafted, Mr. Johnson, there was not any provision, was there, that provided for payment of eight per cent to the stockholders irrespective of earnings?

A. I don't know.

Q. So that actually the stockholders had no guarantee that they would be paid eight per cent, because the provision was for dividends in the charter wasn't it?

A. Well, no, except that the very provisions relating to the stock guaranteed and carried the full faith and credit of the corporation and naturally enhanced its chances of paying it off according to its contract. I think that that was relied upon by the parties all along, that it would be. [fol. 61] paid, and, to answer your point, that it would be paid out of the net earnings of the company.

Q. Who were the principal buyers of this issue of four hundred shares of original preferred stock?

A. Who were the principal buyers?

Q. Yes.

A. Myself, Mr. Wierick, Mr. Irwin and his mother, Mr. E. H. Ratcliff of Dallas. Miss Pearl Beaird. Mr. Ratcliff and Mr. Beaird took preferred stock for obligations which the company owed them——

Q. (Interrupting:) We are talking about the original issue of the preferred stock of four hundred shares.

A. Let me get a memorandum, Mr. Fisher. I think I have it. As to the first issue there were forty shares to Mr. E. H. Ratcliff, Jr.; Mr. J. F. Atkins, one hundred shares; Lillian Pearl Beaird, one hundred shares; and L. J. Dale, seven shares; Mrs. Bessie Blue, sixty; Byron A. Irwin, forty-three; Melvin F. Johnson, forty and C. W. Wierick, Jr., ten, making a total of four hundred.

Q. How many were owned by Mr. Ratcliff?

A. Forty.

Q. Is that the only Mr. Ratcliff who owned preferred stock?

A. In the original issue, yes.

Q. Is that the Mr. Ratcliff who owned a substantial interest in the common stock of the company?

A. No, sir.

Q. Is that his uncle?

A. Nephew, I believe.

Q. This Lillian Pearl Beaird was related to the Mr. J. B. Beaird, who owned a substantial part of the common stock?

A. Daughter.

Q. Do you know whether he bought that stock for her?

A. No, I had something to do with that. That was money withdrawn from a trust at the Commercial Bank, [fol. 62] which was her money. I mean it was her money, but it was withdrawn from a trust that was allowed her when she reached a certain age.

Q. Who are the principal common stockholders of the Hercules Company and have been from the beginning of the company?

A. Mr. J. B. Beaird, Mr. E. R. Ratcliff.

Q. They owned most of the common stock?

A. Yes, sir.

Q. Now, when you amended the charter in 1935 and increased the number of preferred shares you did not at that time consider making any change in the description of the eight per cent to be paid on that as interest rather than dividends, did you?

A. No, I was simply following instructions, Mr. Fisher. I was asked to amend the charter to authorize the issuance of fifty thousand more preferred, and that was the only change I did make, was from four hundred to fourteen hundred shares in the authorized preferred stock.

Q. I assume that under Louisiana law it is not possible for a corporation to pay dividends except out of earnings, is that correct?

A. That is correct.

Mr. Fisher: That is all.

Redirect examination.

By Mr. Jackson:

Q. When you were drawing this charter up in your opinion, so far as Louisiana law was concerned, did it make any difference whether you used the term "dividend" or "interest" or "debt"?

A. No. I was drawing it under the provisions of Act 250 of 1928, the law of Louisiana as construing charters, [fol. 63] and the Courts of Louisiana, I was perfectly aware, always looked with favor upon the purpose and intention of the parties instead of the language used.

Q. You do not mean to imply that that method of construction by the Louisiana Courts is confined just to charters alone?

A. No, sir.

Q. That is the general application of the Courts of Louisiana?

A. Yes, sir.

Mr. Jackson: That is all.

Mr. Fisher: No further questions.

D. W. DEUPREE, a witness on behalf of the Petitioner, after first being duly sworn, testified as follows:

The Clerk: State your full name for the record, please.

The Witness: D. W. Deupree.

Direct examination.

By Mr. Johnson:

Q. You are Mr. D. W. Deupree?

A. Yes, sir.

Q. How long have you resided here?

A. Since 1906.

Q. What is your occupation?

A. Public Accountant.

[fol. 64] Q. What is your position now?

A. In reference to this company?

Q. Well, are you Assistant Secretary of the Hercules Gasoline Company?

A. That is correct.

Q. How long have you been with that company?

A. Since 1906—1936, I mean.

Q. Who has kept the books and records of the Hercules Gasoline Company since you went there in 1936?

A. I have.

Q. Have you made the entries yourself?

A. Yes, sir.

Q. And have you had full charge of the books?

A. Absolutely.

Q. In 1936, or rather let's say 1937, the year in question, did your books show an outstanding preferred stock issue?

A. Yes, sir.

Q. What was the amount?

A. Sixty-four thousand seven hundred dollars.

Q. Had it been the same in 1936?

A. Yes.

Q. When was that item taken off the books?

A. In 1939.

Q. How were the payments on that stock issue carried on your books?

A. As interest.

Q. How did you calculate the interest when it was paid in 1936?

A. I believe I took the stock certificate, the date of the issue of each stock certificate, and calculated the interest.

Q. And in 1937?

A. Provided they were the same stockholders I just used eight per cent.

Q. You just used eight per cent?

A. Yes, figured eight per cent.

[fol. 65] Q. What was that called in your records?

A. Interest.

Q. Do you know if there had been any payments to these so-called preferred stockholders before 1936?

A. No, sir, no record of it.

Q. Your answer is you don't know personally, but the records there did not show any, is that what you mean?

A. Yes, that is correct.

Q. And you computed it when the first payment was made from the date of issue, is that correct?

A. That is correct.

Q. In 1936, Mr. Deupree, did you pay it in cash or with notes?

A. I believe it was entirely in notes. We did not have the cash available then, but we had some obligations that were due in a few months.

Q. How did you carry these items there in 1936 on your books?

A. In notes payable.

Q. Did you have a double entry system of bookkeeping?

A. Yes, sir, I would debit the interest account and credit notes payable.

Q. In 1937 how did you make these entries?

A. In practically the same way.

Q. You debited interest and credited notes payable?

A. Yes, sir, notes payable, or if we paid cash we credited the bank.

Q. In 1937 you paid some in notes and some in cash?

A. I believe that is correct.

Q. Did you make the income tax returns and the information returns to the Internal Revenue Department concerning these payments?

A. Yes.

Q. I show you a pink slip listing income. This is Form number what with reference to the returns that you had to make?

[fol. 66] A. I do not have my glasses. You will have to read it.

Q. 1099.

A. Yes, that is the information return.

Q. Did you or did you not, as assistant secretary and bookkeeper of the Hercules Gasoline Company, issue these returns, information returns?

A. Sure. Yes.

Mr. Johnson: I offer these information returns, or rather this information return, asking that it be identified as Petitioner's Exhibit 13.

Mr. Fisher: Respondent objects to the receipt of this return on the ground it is not possible and legal to go outside of the terms of the stock certificate and the corporate charter to show what these payments were.

The Court: The objection will be overruled, and the exhibit will be received in evidence as Petitioner's Exhibit 13.

(The information return, marked Petitioner's Exhibit 13, was received in evidence.)

By Mr. Johnson:

Q. Mr. Deupree, were similar information returns filed or submitted in 1937?

A. Yes sir.

Q. On the same basis?

A. The same basis.

Q. Mr. Wierick identified a letter which was issued from your department on December 30, 1936 to Mr. Wierick. I will ask you if similar letters were written to all of the

[fol. 67] holders of preferred stock in 1936 such as he identified?

A. Yes, sir, in each interest payment—when each interest payment was made I used these statements.

Q. The letter containing the same statements as this one?

A. Yes sir.

Q. I mean a letter similar to this accompanied each payment?

A. Yes sir.

Q. As in the instance of Mr. Wierick?

A. Yes, sir.

Q. Who prepared the income tax report for the corporation for 1937, or rather the income tax return for 1937?

A. I did.

Q. Are you prepared to state what your books reflected as to your financial condition, I mean the corporation's financial condition, as of December 31, 1937?

A. Yes, sir.

Mr. Fisher. I cannot understand the materiality of these questions, may it please the Court, since there is no issue being raised as to the financial condition of the corporation in connection with 26 C-2.

Mr. Johnson: I think counsel is correct about that, but the only thing that I have as to the reaction of the Commissioner or Respondent with regard to the point that I am bringing up now is an informal unsigned letter from Mr. Fisher to me, and it seems to me that we should be entitled to show that there was not a wilful withholding of dividends, but that our condition in 1937, which is the year involved here, was such that we had no distributable profits, and it is bearing on that point that I am offering this evidence. [fol. 68] I would like to have Mr. Deupree testify on that financial condition. It is no doubt shown in the income tax return, but that return is not in evidence so far, and this deficiency claim makes it important that we make this showing. I think the Court would like to know that condition, and no one is in better position to show it than this witness.

The Court: You may proceed.

By Mr. Johnson:

Q. Mr. Deupree, I will ask you if you have given me figures shown on the sheet which I hand you now showing

the condition of the corporation at the close of business on December 31, 1937?

A. Yes, sir.

Q. Who prepared that?

A. I did.

Q. Where did you get your information?

A. From the balance sheet.

Mr. Fisher: I might state that the memorandum Mr. Johnson is showing me contains some conclusions, and the deficiency letter does not raise any question about the financial ability of the corporation to pay dividends; it only raises the question of whether this is a written contract within the meaning of Section 26 C-2.

I might explain now, as Mr. Johnson mentioned a moment ago, if he is merely offering this is to prove that point, I thought I had stated to him that there would be no issue raised on that point, so that is our ground of objection to the materiality of this evidence.

The Court: You object to the materiality and not to the authenticity?

[fol. 69] Mr. Fisher: Yes, sir, in addition to which this contains conclusions of the witness which we do not agree to, and also this is subject to check with the books, which I have not seen.

The Court: Mr. Johnson, are your records available for checking the accuracy of this?

Mr. Johnson: Yes, sir, I just thought it would save time to do it this way.

The Court: Evidently not.

The Witness: The income tax returns there show that, Your Honor.

Mr. Johnson: We can let him check it with the books during the noon hour.

The Court: Mr. Fisher, did you have some comment that you wanted to make?

Mr. Fisher: Yes, sir. As far as the figures are concerned we will agree to them, subject to check.

The Court: Mr. Johnson, about how much more will there be to your case?

Mr. Johnson: I think I can finish our case within an hour.

[fol. 70] The Court: I think then that we will suspend operations for the time being and return at 2:00 o'clock.

(Whereupon at 12:30 o'clock p. m. a recess was taken in the trial of this case to 2:00 o'clock p. m.)

Afternoon Session

D. W. DEUPREE, resuming the stand at this time, having been previously duly sworn, further testified as follows:

Further direct examination.

By Mr. Johnson:

Q. Mr. Deupree, before the adjournment for the lunch period I believe I asked you about letters sent out with the payments to the holders of the preferred stock, and I asked you if you sent similar letters to the ones that I identified by Mr. Wierick while he was on the stand. Did I ask you that?

A. Yes.

Q. They were all practically the same?

A. Practically the same, yes.

Q. Here is one addressed to Mr. Wierick. You will remember that I asked you to find the letter to Mr. Wierick in 1937 this morning, and through some inadvertence I gave you the letter to Mr. Irwin. Is this a copy of the letter of transmittal to Mr. Wierick taken from your files?

A. Yes, sir, these are the copies.

Mr. Johnson: I offer this copy dated the same date as the letter to Mr. Irwin.

[fol. 71] Mr. Fisher: No objection.

The Court: The letter will be received in evidence as Petitioner's Exhibit 14.

(The letter addressed to Mr. Wierick, marked Petitioner's Exhibit 14, was received in evidence.)

By Mr. Johnson:

Q. Just before lunch we started to go into this question, Mr. Deupree, of some figures that you had prepared from the books concerning your ability to pay dividends. I will ask you if this is the statement you referred to?

A. Yes, sir.

Q. Did you prepare these figures from the books?

A. Yes, sir.

Q. Also did you reconcile them with the return of the corporation in 1937?

A. Yes, sir.

Mr. Johnson: I offer this document in evidence, identifying it as Petitioner's Exhibit 15. It has just been identified by the witness, may it please the Court.

Mr. Fisher: No objection to this, with the understanding that the term "liability" used in connection with preferred stock is not intended to be a legal conclusion as to whether the stock was a liability or not.

The Court: The exhibit will be received in evidence, with that understanding, as Petitioner's Exhibit 15.

[fol. 72] (The statement marked Petitioner's Exhibit 15 was received in evidence.)

By Mr. Johnson:

Q. Mr. Deupree, have you been an accountant all of your life?

A. Practically.

Q. You have been engaged in income tax accounting practically ever since they have had a Federal income tax, have you?

A. Yes, sir.

Q. What is your professional opinion of the financial condition here of the current liabilities of one hundred and seventy-five thousand nine hundred and seventy-one dollars and forty-four cents and the current assets of fifty-one thousand four hundred and seventy-six dollars and sixty-seven cents as to the standing of the company?

A. Well, it would give it a very poor credit rating, I would say.

Q. As an accountant would you consider that that was any condition which would justify the payment of any dividends?

A. I would not recommend that we pay dividends in that condition.

Q. In your calculation of current liabilities did you include the preferred stock?

A. No, sir.

Q. How was that carried on your books?

A. Well, that was—I considered the same as anyone would carry it, not as a current asset—I mean current liability, but a liability to be taken up after the mortgage note was retired, is the way I would look at it.

Q. But do your records show that you had current liabilities of one hundred and seventy-five thousand dollars without including this?

A. Yes, it was a liability.

[fol. 73] Q. It is a judicable issue on the status or the nature of the preferred stock issue, is that correct?

A. Yes, sir.

Q. By the way, this morning while on the stand counsel asked me about certain stockholders. I will ask you if Mr. J. B. Beaird is living?

A. No, sir, he is dead.

Q. He is dead?

A. Yes, sir.

Q. Mr. E. R. Ratcliff?

A. He is dead also.

Q. Mr. Deupree, did you take part in the negotiations or conferences with reference to the claim for surtax liability against the same corporation for the year 1936?

A. Yes, I did.

Q. Did the corporation pay any surtax for undistributed profits for the year 1936?

Mr. Fisher: That is objected to as immaterial. It is in the prior year.

The Court: Objection overruled.

The Witness: No, sir.

Mr. Johnson: In connection with the allegations in the petition, and also in connection with the statement of the accountant, Mr. Deupree, I would like to offer the entire record numbered 95530 in the Board of Tax Appeals, entitled Hercules Gasoline Company, Inc. versus Commissioner of Internal Revenue.

[fol. 74] Mr. Fisher: I object to this offer on the ground that a separate settlement based on a stipulation of deficiency in a prior year can have no bearing on or connection with a determination of a plea of estoppel or res adjudicata, nor in determining the merits of the case in the years 1937 and 1938. It is not a legal determination of what happened in those years but is merely a stipulated settlement of a litigation in a prior year, which, as I understand it,

under the uniform holding of this Court hasn't any legal binding on, and is not even admissible in, proceedings in subsequent years, even if the issue legally were the same.

The Court: This was a case that was settled by stipulation between the parties?

Mr. Johnson: Yes, sir.

The Court: The objection will be overruled.

Mr. Fisher: May I have an exception noted?

The Court: The exception is noted, and the exhibit will be received as Petitioner's Exhibit 16. I might say, Mr. Johnson, that instead of marking it as an exhibit, by agreement you might refer to it, naming the case as you have already done, letting the objection be noted, the record show that the objection is overruled, and the reservation of an exception by counsel for Respondent, and then we will not mark it as an exhibit, but we will take judicial notice of it, because it is one of our own records.

[fol. 75] In this connection, Mr. Fisher, I might refer you to the Farrish case, which you probably recall.

Mr. Fisher: I think that the point we want to bring out is distinguished from the Farrish matter, as we shall attempt to show you later.

I also think, for the purpose of this record, that you better mark it as an exhibit.

(The file in Docket No. 95530 was received in evidence as Petitioner's Exhibit 16.)

Mr. Johnson: In connection, Your Honor, with the last preceding filing I have a letter from Mr. William G. Fuller, head of the Southwestern Division of the Technical Staff accompanying stipulation, which is the last entry in the official record. The purpose of this is to merely show the calculation made by the Commissioner, or the member of the Technical Staff, in arriving at the three thousand eighty-six dollars deficiency which is the only thing in the stipulation.

The Court: That would not be a part of the issue, or the decision on it.

Mr. Johnson: I don't think it would. I would say it is part of my evidence in support of the prior filing to show that the question of whether that preferred stock issue in 1936 fell under 26 C-1 or 2 of the 1936 Revenue Act, and it is to show the application of that Section of the law by the parties to that situation. I do not say that the Court

had that information, but I thought it might be well to supplement the actual figure by showing how it was handled [fol. 76] and considered by the Respondent and his agents and representatives themselves.

The Court: I haven't heard any offer made yet. You just started out to talk about it.

Mr. Johnson: I thought that Mr. Fisher might agree with me on it, or that he might not have any objection to it, because it just occurred to me that it isn't my evidence; it is his. I offer the evidence to show rem itsem, a calculation by the Treasury Department itself in that case which was the basis of the discussion and stipulation in the prior Board of Tax Appeals case.

Mr. Fisher: I object to it on the ground it is immaterial and irrelevant to any issue in this case, and if it is made as an offer of proof in connection with an attempt to estop the Commissioner, or establish a stipulated settlement in that hearing on the merits, then I object to it on the ground that it could not be admissible for such purpose.

The Court: The objection will be overruled and the exhibit received as Petitioner's Exhibit 17.

Mr. Fisher: May I have an exception?

The Court: Let the exception be noted.

(The letter from William G. Fuller, head of the Southwestern Division of the Technical Staff, marked Petitioner's Exhibit 17, was received in evidence.)

[fol. 77]. By Mr. Johnson:

Q. Mr. Dupree, did you attend any conference or conferences as a representative of the taxpayer with the representatives of the Commissioner which led up to the settlement of the 1936 question?

A. Yes, sir.

Q. Do you recall whether when the 1936 matter was being discussed and gone into, whether the 1937 matter was considered?

Mr. Fisher: Objected to on the ground that it is immaterial, and all of the documents in evidence would speak for themselves as to what the settlement was. I do not think that anything in this case was settled, or that it had any materiality in the other case, but certainly the documents would speak for themselves.

The Court: In 1937—what year are you talking about?

Mr. Fisher: I should have said 1936—the settlement of 1936. The year we have here is 1937 and also we have 1938.

The Court: Read the question.

(Whereupon the reporter read the last question as hereinbefore recorded.)

The Court: You have in the stipulation, and I take it, as a part of that file you have the decision of the Court entered on that stipulation. I allowed you to put in the document which you say accompanied the stipulation as information coming to you from the head of the Technical [fol. 78] Staff in this area as the basis for it, but I think we are going a little bit far afield regarding discussions back and forth in connection with what took place. If we go into that we could go back to the Revenue Agents, their examinations, and the results of whatever took place when they were making the examination, and there would just be no end to the testimony that would be brought in. I do not think that discussions that might have taken place at the time of the conferences and so forth should be admitted, and I shall have to sustain the objection to it. Is that your purpose?

Mr. Johnson: Our purpose isn't to go into the actual things that were said, nor is it our purpose to show any written terms other than as shown by the exhibits themselves, but to show merely that it was an advised and deliberate calculation resulting from the conference itself. In other words, it was not something that was just got up on the spur of the moment without preliminary and full and complete discussions, but that it was the result of full and complete and deliberate discussions and considerable deliberations over the subject.

The Court: I still do not think that we will admit any testimony on the discussions that took place at those conferences. Of course quite frequently when stipulations are entered into they are the results of deliberations and conferences by the parties, and sometimes they may be made with the idea that they will settle some questions for years to come, but it would not be binding on a future case, because the circumstances may be different, or the parties might be different. I do not think it is admissible, Mr. Johnson, and I shall have to sustain the objection.

[fol. 79] By Mr. Johnson:

Q. Mr. Deupree, had the Commissioner already made demand for the 1937 surtax at the time and preceding the settlement of the 1936 case?

Mr. Fisher: That is objected as to being irrelevant and immaterial.

Mr. Johnson: I think, Your Honor, it is material to show whether or not he had already demanded it.

The Court: That depends on what you mean by "demand". There are lots of communications that go back and forth in these cases before they reach the stage of assessment or settlement. They have Revenue Agents making checks, and they have other Revenue Agents making inquiries as to certain data, and one agent may be working on one return, while another agent is working on another return a year or two later, and while one case may be in the process of settlement the other may be in the process of investigation, or there may have been a determination of deficiency in both years by the time it goes to the deficiency notice, but they are not included in the same ultimate deficiency notice, and things of that kind.

Before we go into that I would like to know just what you are inquiring about here because, for instance, Revenue Agents reports are not evidence of anything except what the Revenue Agent himself has put down, and his statements do not constitute evidence of the facts, and are not binding in any manner. I do not want to cut out any proper evidence or inquiry, but I do not want to get into any discussions or conferences and communications which are preliminary to the determination of nothing.

Now, notice and demand have very technical and definite meanings under the Revenue Act. There might be all sorts [fol. 80] of discussions about an alleged deficiency between the Commissioner's agents and the taxpayer, but until the assessment had been entered on the assessment rolls by the Commissioner and a formal demand made upon the taxpayer to pay the assessment there might not be any technical demand made. As I say, these terms have a definite meaning under the Revenue Act, and I want to see what you are talking about before we proceed.

Mr. Johnson: Your Honor, it seems to me that this testimony is admissible on several grounds. The first ground would be estoppel. We allege in the petition that we agreed

to something, and we take the position that the Commissioner agreed to it, and on the basis of the settlement which we arrived at we considered we were settling the 1936 and 1937 matter and we paid the tax.

The Court: Paid what tax?

Mr. Johnson: Three thousand eighty-six dollars.

The Court: For what year?

Mr. Johnson: I think it is on the question of estoppel.

The Court: I say, for what year did you pay the tax?

Mr. Johnson: 1936, but so tax on undistributed profits. I mean there were several issues in that case, but that was one of them. I think it is admissible as an admission by the [fol. 81] Respondent in a case where the issue was joined and where all of the parties were aware of the facts, and as involving the principle where, as Judge Holmes stated in the Supreme Court case, the Commissioner should turn square corners with the citizen.

The Court: And he said that the taxpayer should turn square corners with the Commissioner also. I think this is would be too remote a proposition on the questions of estoppel in this case.

Mr. Johnson: I don't think it would be. I take Mertens for it.

The Court: Mertens is not conclusive, of course, but to what do you refer?

Mr. Johnson: On the question of estoppel. Of course it may be a doubtful question, but here is what Mertens says:

"There are intimations that estoppel, if properly proved might prevail against the Commissioner. In several instances, the Commissioner or the collector has been held precluded from adopting a position inconsistent with one previously taken where injustice would result therefrom. In other instances, the Department has been held bound by its misrepresentations to the taxpayer."

Then he cites a number of cases under that which are pertinent to the question, and I think that the Commissioner having through his representatives made an agreement and stipulation based on certain facts should be made to stand by that action. I think it is admissible under that theory, [fol. 82] and also under my plea of res adjudic-ta. This settlement in 1936 could only be made by recognition of the Commissioner that our charter and preferred stock issue

was a contract which would have to be violated in order to distribute undistributed earnings of the company. I do not think that that fact, even though it is a stipulation, keeps it from res adjudicata, because it was a stipulation of the facts by the Commissioner, approved and confirmed by the Board of Tax Appeals. It was not a price paid for peace; it was an admission and recognition that the corporation could not distribute these profits without violating the contract as shown in the charter and preferred stock.

So I say that it seems to me that this testimony is admissible as a declaration against interest under our plea of estoppel, and under our plea of res adjudicata, and the Court should hear all the evidence we have on these points.

The Court: Of course in the case pending before the Court, or the Board of Tax Appeals I take it was in the year 1936, the Board of Tax Appeals had before it only hearsay as far as 1937 was concerned. There was nothing on the 1937 matter. There was nothing for 1937 be it a document, or stipulation of the parties, or otherwise, according to the record which you have put in evidence.

Now there are two types of what is termed res adjudicata, although there is some question as to whether technically both types of determining it would be proper. One type is estoppel by judgment. Now, you have fixed the basis for arguing that already in the record. Discussions that might have been had on the side with respect to 1937 as a prospective matter not then judicially determined, and while I am willing to allow, and I do allow in the making of a record a great deal of latitude, and while we scarcely or very seldom sustain objections based on materiality, we [fol. 83] have had this question of estoppel, this form of estoppel against the Commissioner of Internal Revenue in respect to discussions had between taxpayers and representatives and agents of the Commissioner before us, we have never sustained them.

Here you have a situation where by stipulation of the 1936 case you arrived at certain computations and facts which you state to be a factor of how such figures were arrived at. It is evidence of nothing more than the fact that that case was settled by the Board, based on a stipulation between the parties, and I think it is a well-settled rule of the Board that such is not a basis of estoppel in any

year thereafter and I am not going to confuse the record by admitting it.

I could be wrong in my ruling, but I don't think I am. I shall sustain the objection.

Mr. Johnson: I take it that the reporter will note an exception to the Court's ruling not only to the last question but on that same line leading up to it bearing on the same point.

The Court: I do not know just what the result may be, but if you think it is necessary the exception may be so stated.

By Mr. Johnson:

Q. Mr. Deupree, had the assessment sheets, the assessment of surtax for 1937, been brought up by the Internal Revenue Agent in Charge in New Orleans preceding the settlement of the 1936 case?

Mr. Fisher: That is objected to on the same ground

Mr. Johnson: That isn't going into exactly what I asked before. I just want to establish the point of our relation as [fol. 84] between the agents and parties, to let the Court know whether or not it was being considered, or had been considered.

Mr. Fisher: I have no objection to stipulating that it was under consideration, not by the Technical Staff, but by the Revenue Agents office.

Mr. Johnson: That is correct. Then is it agreed and stipulated that the Internal Revenue office had under consideration with the taxpayer the question of surtax on undistribtued profits for 1937 at the time the 1936 Board of Tax Appeals suit was stipulated?

Mr. Fisher: I will make it better for you even than that. I understand that the 1937 case had been investigated and was under consideration by the office of the Internal Revenue Agent in Charge at New Orleans at the time that stipulation was made in the 1936 case between the taxpayer and the Commissioner, who was represented by the Technical Staff and the chief counsel's office of the Bureau of Internal Revenue, which is a different office from the Revenue Agent in Charge at New Orleans; that the 1937 case was not before the office of the Technical Staff or the chief counsel at the time of the settlement of the 1936 case. That is as far as we are willing to go.

Mr. Johnson: Witness tendered.

Cross-examination.

By Mr. Fisher:

Q. Mr. Denpree, in your professional experience before going with the Hercules Company in 1936 did you ever see [fol. 85] a case where payments on preferred stock were called on the books "interest"?

A. Well, I do not believe I ever had a case like that. I do not recall any at present.

Q. Was there any interest calculated, so-called interest calculated, on this preferred stock of the Hercules Company before 1936?

A. No, sir.

Q. Was there an account on the books entitled "interest"?

A. In 1936?

Q. Yes.

A. Yes.

Q. Was there an account on the books for prior years, 1933 to 1936, entitled "interest"?

A. Well, yes.

Q. But no so-called interest was put of record on these accounts for this preferred stock?

A. No, sir, that is no record that I could find.

Q. Was it your suggestion, or at your suggestion, that this so-called interest was first put on the books of the Hercules Company?

A. You mean my suggestion?

Q. Yes.

A. Well, I thought it should be set up on the books, yes.

Q. Was yours a general practice in accounting before you went with the Hercules Company?

A. Yes.

Q. You had had experience in income tax matters?

A. Yes, sir.

Q. In your work before you went with the Hercules Company?

A. Yes, sir.

Mr. Fisher: No further questions.

[fol. 86] Redirect examination.

By Mr. Johnson:

Q. Mr. Deupree, when were the first dividends paid to the common stockholders?

A. I believe in 1939.

Q. Were any dividends paid before the complete retirement of all preferred stock?

A. No, sir.

Mr. Johnson: That is all.

Mr. Fisher: No further questions.

Mr. Johnson: Will the Court give us a few minutes to confer?

The Court: Yes. We will take a few minutes intermission.

(Whereupon at this point there was an intermission for a few minutes.)

After Intermission

Mr. Johnson: If Your Honor please, we are ready to proceed.

The Court: All right, proceed.

D. W. Deupree, being recalled by counsel for Petitioner, having been previously duly sworn, testified as follows:

[fol. 87] Direct examination.

By Mr. Johnson:

Q. Mr. Deupree, I will ask you if Mr. J. B. Beaird and Mr. E. R. Ratcliff had personally indorsed the various obligations of the corporation, and particularly that fifty thousand dollar mortgage referred to by you in this exhibit as to the financial condition?

Mr. Fisher: May I ask the purpose of this question?

Mr. Johnson: Yes. This morning you asked me who were the principal stockholders, if you will remember.

Mr. Fisher: Yes, sir.

Mr. Johnson: It just seems to me to be pertinent to bring out that Mr. Beaird and Mr. Ratcliff were personally liable on this prior obligation of fifty thousand dollars. I do not think that you would dispute that.

Mr. Fisher: I have no objection.

The Court: You may answer the question.

The Witness: Yes, sir, they were both indorsers on those papers.

By Mr. Johnson:

Q. And on various other——

A. (Interrupting:) And on various other papers, yes, sir.

[fol. 88] Mr. Johnson: That is all.

Cross-examination.

By Mr. Fisher:

Q. Was that indebtedness secured by properties of the corporation?

A. Some of it was and some of it wasn't.

Q. In the instance that you mentioned there a moment ago, that fifty thousand dollar obligation, was that secured by properties of the corporation?

A. Yes, sir.

Q. Did Mr. Beaird and Mr. Ratcliff own almost all of the common stock of the corporation?

A. Well, yes, practically all of it.

Mr. Fisher: I think that is all.

Mr. Johnson: I believe that is our case. Petitioner rests.

The Court: Anything from the Respondent?

Mr. Fisher: Respondent rests.

Mr. Johnson: Does counsel or the Court wish argument, or simply the filing of briefs in this case?

The Court: I think it very desirable in this case that briefs should be filed. It would be much better. That is true in most all cases, but in this particular case it is much more [fol. 89] desirable. There are several points in this case which require considerable study and consideration by me, and there has been considerable documentary evidence which I am unable to carry in my mind, and your argument at this time, without me having that firmly fixed in my mind, would be almost useless, Mr. Johnson. You will have forty-five days within which to file your original brief.

Mr. Fisher: I think I would like to have serial briefs filed in this case.

The Court: All right, if there is no objection I will fix forty-five days for the original brief of Petitioner, and

then thirty days for the Respondent, and then fifteen days for the reply brief of the Petitioner.

Mr. Johnson: Does that mean that we are to have forty-five days from this date, or forty-five days from the completion of the transcript by the reporter?

The Court: No, Mr. Johnson, that means your brief will have to be in within forty-five days from the close of this hearing.

Mr. Johnson: I just wanted to be certain about it, may it please the Court: If I can get a transcript of the testimony, I can have my brief in within thirty days, or even within twenty days, as far as that is concerned. It will be all right for me to file it within that time, I assume.

Mr. Fisher: Yes, but I would like for the full time to run, because I am going to be in some other hearings at other points in the meantime, and I would like to know that I am going to have thirty days from the end of the forty-five days that the Petitioner has.

[fol. 90] The Court: Yes. That is true. You will have the right. That does not preclude Mr. Johnson from getting his in before the forty-five days is up, if he desires. Is there anything else?

Mr. Johnson: No, sir.

Mr. Fisher: No, sir.

The Court: Then the case will stand submitted upon the filing of briefs.

(Whereupon at 3:07 o'clock p. m. the hearing was adjourned.)

ORDER RE VERBATIM TRANSCRIPT OF TESTIMONY AND ORIGINAL EXHIBITS—Filed October 23, 1944

IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

[Title omitted]

On Motion of Melvin F. Johnson, attorney for Hercules Gasoline Company, Inc., Petitioner, in an appeal from the Tax Court of the United States in the matter entitled "Hercules Gasoline Company, Petitioner, vs. Commissioner of Internal Revenue, Respondent," Tax Court Docket No. 111038, and on suggesting to the Court that the official stenographic report of the proceedings is not a long tran-

[fol. 91] script and better presents the testimony and evidence than could be done by statement, all of it being material to the assignments of error, and on suggesting to the Court that mover desires an order directing the Clerk of the Tax Court of the United States to send up a verbatim transcript of the testimony heard by the Tax Court of the United States in lieu of a statement of the evidence; and averring that the original exhibits filed before the said Tax Court better present the facts than copies would do, and further suggesting to the Court that mover desires also to have the original exhibits to be transmitted in the original.

It is Ordered by the Court that the Clerk of the Tax Court of the United States, in preparing the record of the above case, forward a verbatim transcript of the testimony in lieu of a statement of the evidence and also forward the exhibits in the original.

October 17, 1944.

(Signed) Saml. H. Sibley, United States Circuit Judge; (Signed) Melvin F. Johnson, 1026 Giddens-Lane Building, Shreveport 4, Louisiana, Att'y. for Hercules Gasoline Co., Inc., Petitioner.

Clerk's Office

Attest: A True Copy. Oakley F. Dodd, Clerk, U. S. Circuit Court of Appeals, Fifth Circuit. (Signed) by E. Wendling, Deputy Clerk. (Seal.)

New Orleans, La. October 20th, 1944.

[fol. 92] IN THE TAX COURT OF THE UNITED STATES

Docket No. 111038

HERCULES GASOLINE COMPANY, INC., Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Melvin F. Johnson, Esq., for the petitioner; Homer J. Fisher, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

TURNER, Judge:

The respondent has determined deficiencies in tax as follows against Hercules Gasoline Company, Inc. (Louisi-

ana), and that petitioner, as transferee of the assets of that corporation, is liable for such deficiencies:

Year	Income Tax	Excess Profits Tax
1937	$34,885.98	$862.49
1938	258.75	

Issues presented by the pleadings are whether the respondent erred (1) in failing to allow certain deductions for 1937 and 1938 on account of depreciation and abandonment of plant, pipe lines and equipment; (2) in disallowing in 1937 and 1938 deductions taken as interest paid on preferred stock; and (3) in disallowing credit against undistributed profits tax for 1937. At the hearing the petitioner abandoned issue (1), thus leaving for determination only issues (2) and (3).

Findings of Fact

The petitioner is a Delaware corporation, organized in 1939, and domiciled in Wilmington. It admits liability as [fol. 93] transferee of the assets of Hercules Gasoline Company, Inc., which was organized under the laws of Louisiana in 1933, and was dissolved in 1939.

The original charter of the Louisiana corporation, sometimes hereafter referred to as the transferor, was filed with and recorded by the Recorder of Caddo Parish, Louisiana, on May 11, 1933, and contained the following:

Article II

The objects and purposes for which this corporation is formed are hereby declared to be: * * * to borrow money and to issue, sell, pledge, or otherwise dispose of its bonds, debentures, promissory notes, bill of exchange and other obligations and to secure same by mortgage, pledge or other hypothecation of any kind of property; to acquire by purchase or otherwise its own shares;

* * * * * * *

Article V

The Capital stock of this corporation is hereby fixed at 8,000 shares of no par value common stock and 400

shares of $50.00 par value of preferred stock, which said stock shall be paid for in cash at the time of issuance or for service rendered or property actually received and shall be full-paid and nonassessable.

The following rights, privileges and conditions shall attach to the shares aforesaid, viz:

(a) The preferred stock shall be entitled, out of any and all surplus net profits whenever declared by the Board of Directors, to cumulative dividends at the rate of 8% per annum for each and every year from [fol. 94] the issuance of such stock, payable semi-annually, in preference and priority to any payment of any dividend on the common stock for such year.

(b) The Board of Directors shall have the right to redeem any or all of the preferred stock at 102 ($51.00 per share) on any dividend date after giving thirty days written notice to the shareholder, and preferred stock thus redeemed and discharged shall not be reissued.

(c) The common stock shall be subject to the prior rights of the holders of the preferred stock as above declared and there shall be no dividend on the common stock until all of the preferred stock has been retired, redeemed and discharged.

(d) Each share of common stock shall be entitled to one vote at all shareholders meetings of the corporation. The holders of preferred stock shall have no voting powers whatsoever, nor shall they be entitled to notice of any meeting of stockholders.

. . . . . .

Article XII

The corporation shall have authority to purchase and/or redeem its own shares of stock out of surplus available for dividends as per Sections 23 and 45 of Act 250 of 1928.

At a meeting of the stockholders of the transferor, held on September 16, 1935, a resolution was adopted to amend the charter so as to increase the authorized number of shares of preferred stock from 400 to 1,400. Thereafter on

[fol. 95] October 3, 1935, the amendment to the charter was filed and recorded. The amendment as contained in the resolution and as made to the charter was in the same language as that contained in Article V of the original charter, except that the number of shares of preferred stock was shown as 1,400 instead of 400. After authorizing an amendment to the charter to increase the amount of preferred stock, the stockholders, at the same meeting, adopted the following resolution:

> Resolved, that the preferred stock be issued at par to any creditor willing to accept same in full payment of his claim.

All certificates of preferred stock, whether issued before or after the amendment to the charter, contained the following provision on the face thereof:

> For Rights and Voting Powers of Preferred Stock See Article V of Charter.

During 1937 and 1938 the transferor had outstanding 1,294 shares of preferred stock of a total par value of $64,700, all of which had been issued prior to May 1, 1936, and all of which was retired in 1939.

In making certain sales of preferred stock, J. B. Beaird, president of the transferor, represented to purchasers that the money invested in the preferred stock would be repaid with 8 percent cumulative "interest," and would be paid in full before any other stock obligations of the transferor were paid, or before any dividends were paid on the common stock. No representations were made as to any particular date when the amount invested in the preferred stock would be repaid, or that the payments of 8 percent would be made regardless of whether the transferor had any earnings.

[fol. 96] So far as disclosed, no payments were made prior to 1936 with respect to the 8 percent per annum on the shares of preferred stock. Nor prior to 1936 were any entries made on the transferor's books recording the annual amounts of such percent as interest, although an interest account was carried on the books. During 1936, D. W. Deupree entered the employ of the transferor as assistant secretary and bookkeeper, and kept its books until it was dissolved. Before entering the employ of the trans-

feror, Deupree had been engaged in practice as a public accountant and had been handling income tax matters practically ever since there had been a Federal income tax law. At his suggestion, percentage payments made on the transferor's preferred stock were entered as interest on its books. However, in his practice he had never seen a case where payments on a corporation's preferred stock were treated as interest on its books. In resolutions adopted by the transferor's directors at meetings held in December 1936, December 1937, January 1939, and May 1939, authorizing percentage payments on the transferor's preferred stock, such payments were referred to as interest on the preferred stock. In the transmittal notices accompanying checks issued to holders of preferred stock, and in information returns filed with the State and Federal tax authorities, the percentage payments were also referred to as interest. At least one holder of preferred stock reported the percentage payments as interest in his Federal income tax returns.

In its income tax returns for 1937 and 1938, the transferor deducted as interest the amounts of $4,696 and $5,148, respectively, representing the percentage payments on its preferred stock. In determining the deficiencies for those years, the respondent determined that the amounts were dividends paid on preferred stock and disallowed the deduction of them as interest.

In determining the deficiency for 1937, the respondent determined that the provision in the transferor's charter [fol. 97] which prohibited the payment of dividends on common stock so long as any of the preferred stock was outstanding did not constitute a contract prohibiting the payment of dividends within the meaning of section 26 (c)(1) of the Revenue Act of 1936. Accordingly, for the purpose of computing the undistributed profits tax for 1937, he allowed no credit, except the amount of $4,696 deducted by the transferor as interest paid on its preferred stock but determined by respondent to be dividends paid on such stock.

As shown by the books of the transferor, it had current assets in the amount of $51,476.57 and current liabilities of $175,971.44, at December 31, 1937. Said amount of liabilities did not include a first mortgage loan of $50,000, which was being paid in monthly intallments of $7,500 each.

In determining a deficiency in tax of $15,017.86 against the transferor for 1936, the respondent allowed no credit of any kind for the purpose of computing the tax on undistributed profits and computed a tax on such profits at $11,972.10. The transferor filed a petition, docketed at Docket No. 95530, with the Board of Tax Appeals against the determination of the deficiency. Among the errors assigned, was the respondent's disallowance of credit against undistributed profits tax because the charter provision restricting the payment of dividends on common stock was not a contract in prohibition of the payment of dividends under section 26 (c) of the Revenue Act of 1936. Respondent denied error. Thereafter, and without any trial being had, the parties filed a stipulation, in which it was stated that the amount of the deficiency was $3,086.70, and that the Board might enter its decision accordingly. Thereupon the Board entered its decision determining the amount of the deficiency to be as stated in the stipulation.

The stipulation contained no statement of facts, nor any explanation as to how the amount of the deficiency stated therein was computed. Evidence submitted in the present [fol. 98] proceeding discloses that it was based on a computation made by respondent, in which a dividends paid credit of $73,749.90 was allowed. That amount was in excess of both the taxable net income and the adjusted net income as shown in the computation, and the allowance of it resulted in there being no undistributed net income. The record does not show what item or items entered into the computation of the $73,749.90.

Opinion

The petitioner contends that the transferor's preferred stock was not stock, but indebtedness, and that the payments made with respect thereto during the years 1937 and 1938 were payments of interest, not payments of dividends, and as interest constituted allowable deductions for those years.

That the contention of the petitioner is without merit is, we think, evident from the provisions of the corporate charter under which the preferred shares were issued. The charter fixed the transferor's capital stock at no par value common and $50 par value preferred. With respect to the preferred stock, it provided that "out of any and all sur-

plus net profits," such stock should be entitled "whenever declared by the Board of directors to cumulative dividends at the rate of 8% per annum for each and every year from the issuance of such stock * * * in preference and priority to payment of any dividend on the common stock for such year." The preferred stock was redeemable at $51 per share on any dividend date, after 30 days' written notice, the right to call such stock for redemption being in the transferor's board of directors. No dividends could be paid on common stock until the preferred stock had been retired, redeemed and discharged. Such being the charter provisions governing the preferred stock, its issuance and the rights of the holders thereof, we think it apparent that the relationship between the transferor and the holders [fol. 99] of the preferred shares was not that of debtor and creditor, but that of corporation and stockholder. The shares had no maturity date, and the holders had no prior right to any payment thereon or thereunder except as to the holders of the common stock. There was no unconditional liability to pay any sum and no amount was payable in any event. The so-called interest distributions were payable only out of surplus net profits when declared by the board of directors. The board of directors had no power to make the payments from any other source. The status of the holders of the preferred shares was obviously inferior to that of regular corporate creditors and was superior only to that of common shareholders. The fact that the transferor's president may have represented to prospective purchasers that the amounts invested in preferred shares would be repaid with interest and the further fact that the transferor entered the distributions made thereon on its books as payments of interest are in no way controlling. Such representations cannot and do not make of the preferred shares something they are not. The payments here in question were the payments of dividends and not payments of interest, and are not therefore deductible in determining transferor's net income. See and compare *John Kelley Co.*, 1 T. C. 457.

The petitioner contends that the provision in the transferor's charter prohibiting the payment of any dividends, except on preferred stock, until all of the preferred stock had been retired, and the incorporation of such provision by reference in the preferred stock certificates amounted to "a written contract executed by the corporation" re-

stricting the payment of dividends within the meaning of section 26 (c)(1) of the Revenue Act of 1936, and that the respondent erred in failing to allow any credit with respect thereto in determining transferor's undistributed profits tax for 1937. In support of its contention, the petitioner relies on *Lehigh Structural Steel Co.* v. *Commissioner* (C. C. A., 3rd Cir.), 127 Fed. (2d) 67; and *Rex-Hanover Mills* [fol. 100] *Co.*, v. *United States* (Ct. Cl.), 53 Fed. Supp. 235, decided January 6, 1944. The respondent concedes that the decisions in those cases support petitioners' contention but points out that all the Circuit Courts of Appeals, except the Third Circuit, which have passed on the question, as well as this Court, have reached a contrary conclusion to that reached in the cases relied on by petitioner. In *Senior Investment Corporation*, 2 T. C. 124, promulgated June 15, 1943, on appeal to the Circuit Court of Appeals for the Sixth Circuit, we reviewed the status of the decisions involving the question whether charter and stock certificate provisions retricting the payment of dividends constitute a contract within the puryiew of 26 (c)(1). We found that the Circuit Court decision in the *Lehigh Structural Steel Co.* case stood alone, and declined to follow it. In addition to the decisions mentioned and relied on by us in *Senior Investment Corporation, supra*, see also, *France Stone Co.* v. *Commissioner* (C. C. A., 6th Cir.), 135 Fed. (2d) 463, certiorari denied, 319 U. S. 742. In that case, it was held that provisions in the corporate charter and in the preferred stock certificates requiring that before dividends were paid on other classes of stock five percent of the earnings of each year should be set aside to provide a sinking fund for the retirement of preferred stock did not constitute a contract restricting the payment of dividends within the meaning of section 26 (c)(1). We find nothing in the decision in *Rex-Hanover Mills Co.* v. *United States*, *supra*, to warrent a departure from the position heretofore taken by us on the question here presented. In view of the foregoing, the contention of the petitioner is denied.

The petitioner contends that the settlement of the transferor's tax liability for 1936 is *res judicata* of the question presented here, and that the respondent is estopped to contend that the charter and stock certificate provisions prohibiting the payment of dividends on common stock until all of the preferred stock had been retired did not

[fol. 101] constitute a contract prohibiting the payment of dividends within section 26 (c)(1), *supra*.

Since the parties voluntarily and completely settled the 1936 case by stipulation of the correct tax liability and the Board's decision was entered thereon, and since the tax liability of the transferor for the years in controversy herein constitutes a different cause of action, the petitioner's contention cannot be sustained. *Margaret A. C. Riter*, 3 T. C. 301.

The petitioner makes the further argument that the transferor "was unable to distribute profits in 1937 because it had none to distribute." Apparently it is the petitioner's view that the absence of undistributed profits is demonstrated by the fact that at December 31, 1937, "current liabilities" were substantially in excess of "current assets". We are further told of a $50,000 first mortgage loan, but we have no showing of the transferor's other assets and there is no claim that it had a deficit, operating or otherwise. The failure of proof to support the argument here made is also accented by the facts that the deficiency notice shows undistributed net income for 1939 as $159,935.47. Aside from the issue involving the deductibility, as interest, of the percentage payments on preferred stock, the petitioner urges no issue affecting said amount of profits, and there is nothing of record to indicate that such amount was not correct. Such being the state of the record, the argument here made is without merit.

The petitioner contends that the respondent's action in determining that the charter and stock certificate provisions prohibiting the payment of dividends on common stock until all of the preferred stock had been retired was not a contract within the provisions of section 26 (c)(1), *supra*, was arbitrary, capricious and discriminatory, and therefore unconstitutional. As heretofore indicated, we are of the opinion that the respondent's action in this respect was in accord with the provisions of section 26 (c)(1). The constitutionality of that section was sustained in *Helvering*, [fol. 102] v. *Northwest Steel Rolling Mills*, 311 U. S. 46. The contention of the petitioner is accordingly denied.

Enter:

Decison will be entered for the respondent.

Entered Jul. 31, 1944.

IN THE TAX COURT OF THE UNITED STATES

Docket No. 111038

HERCULES GASOLINE COMPANY, INC., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion, entered July 31, 1944, it is

Ordered and Decided: That there are liabilities on the part of this petitioner for income tax and excess profits tax together with interest thereon as provided by law, as follows, as transferee of Hercules Gasoline Company, Inc. (Louisiana):

Year	Income Tax	Excess Profits Tax
1937	$34,885.98	$862.49
1938	258.75	

Enter:

Entered Jul. 31, 1944.

(Signed) Bolen B. Turner, Judge. (Seal)

[fol. 103] IN UNITED STATES CIRCUIT COURT OF APPEALS, FIFTH CIRCUIT

PETITION FOR REVIEW

Received Oct. 9, 1944

Filed Sept. 28, 1944

Hercules Gasoline Company, Inc., the appellant in this case, hereby files petition for review by the United States Circuit Court of Appeals for the Fifth Circuit of a decision of the Tax Court of the United States, entered July 31, 1944.

I. Jurisdiction

Your petitioner is a corporation duly organized under the laws of the State of Delaware, having its principal office and place of business at Shreveport, Louisiana.

The appellant filed its income and excess profits tax returns for the years in question; namely, the taxable years ending December 31, 1937 and December 31, 1938, with the Collector of Internal Revenue at New Orleans, Louisiana, which office is located within the jurisdiction of the United States Circuit Court of Appeals for the Fifth Circuit, where this review is sought.

This petition for review is brought pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

II. Prior Proceedings and Facts

On February 27, 1942, the appellee (respondent below) sent to the appellant a notice of deficiency, as prescribed by the provisions of Section 272(a) of the Internal Revenue [fol. 104] Code. Said notice showed a deficiency in income and excess profits tax against Hercules Gasoline Company, Inc., a Louisiana corporation later dissolved and of which the appellant is transferee, for the taxable year 1937, in the amount of $35,748.47, and a deficiency in income tax for the taxable year ending December 31, 1938, in the amount of $258.75.

Said deficiency grew out of numerous adjustments made by the appellee to the tax return of Hercules Gasoline Company, Inc., (La.) for the years in question, involving principally the denial by appellee of a credit against surtax on undistributed profits of the corporation for the year 1937, for which the corporation claimed credit by virtue of a contract expressly prohibiting dividends between the corporation and the holders of preferred stock; also including refusal by the appellee to allow depreciation and abandonment of assets, also interest payments by the corporation to holders of the so-called preferred stock.

On May 14, 1942, the appellant filed a petition to the United States Board of Tax Appeals (now the Tax Court of the United States) seeking a redetermination of its tax liability for the years in question and alleging that the appellant erred in making each and every one of the adjustments.

The Commissioner filed answer under date of June 24, 1942, making general denial to petitioner's claims and praying that the appeal be denied.

Thereafter, on December 7, 1943, the cause came on for hearing before the Tax Court of the United States, Hon. Bolon B. Turner, Judge, presiding.

On July 31, 1944, said Tax Court promulgated its findings of fact and opinion and upon the same date entered an [fol. 105] order specifying the amount of income and excess profits taxes as follows, to-wit:

Ordered and Decided: That there are liabilities on the part of this petitioner for income tax and excess profits tax, together with interest thereon as provided by law, as follows, as transferee of Hercules Gasoline Company, Inc. (Louisiana):

Year.	Income Tax	Excess Profits Tax
1937	$34,885.98	$862.49
1938	258.75	

III. Nature of the Controversy

On the trial date, petitioner waived the matters of depreciation schedule and abandonment because its principal witnesses in these matters were now deceased and, finally the questions presented to the Tax Court, claimed by petitioner and denied by the Commissioner, were:

1. Petitioner should be allowed credit against undistributed profits tax under Section 26 (c)(1) of the Revenue Act of 1936 because of the written contract executed by the corporation prior to May 1, 1936, expressly dealing with the payment of dividends, included in the charter and preferred stock certificates.

When the Louisiana charter was filed on May 11, 1933, it contained the following language in Article V subsection c, to-wit:

"The common stock shall be subject to the prior rights of the holders of the preferred stock as above declared and there shall be no dividend on the common stock until all of the preferred stock has been retired, redeemed and discharged."

[fol. 106] This stipulation was carried on the face of the certificates of preferred stock by the following language:

"For rights and voting powers of preferred stock, see Article V of Charter."

It was expressed on the common stock certificates by the following language:

"For rights and voting powers of common stock, see Article V of Charter."

2. The corporation was financially unable to pay any dividends in 1937 because it had no surplus or undistributed profits to distribute.

The appellant proved, without contradiction, that it had current assets of about $51,000.00 and current liabilities in the sum of about $176,000.00, as of December 31, 1937, without adding to the liabilities the outstanding preferred stock issue in the sum of $64,700.00 and a first mortgage loan of $50,000.00. Therefore, even if the contract credit is not given the corporation was not in position to pay a dividend because it had no cash, credit or net profits available for distribution. The contentions of the Commissioner that dividends might have been paid with borrowed money disregards the facts and is an attempt by the Commissioner to substitute his judgment for that of the corporate officers.

3. The Commissioner, having acknowledged the "contract" prohibiting dividends by the same corporation in 1936, should not be permitted now to change his ruling involving identical issues, and he should be estopped.

It was shown upon trial in the Tax Court that the same "contract" issue had been drawn between the taxpayer and [fol. 107] Commissioner concerning the 1936 tax return of the corporation and after appeal to the Board of Tax Appeals, the Commissioner formerly had allowed full credit for the "contract" now contended for and that the Tax Court had entered an order concluding the case and relieving the corporation of all surtax on the stipulation of counsel.

4. The payments made by the corporation to the holders of preferred stock during 1937 and 1938 were interest payments and should be allowed as deductions.

Your appellant adduced evidence at trial concerning the interest vs. dividends question, showing that the corporation had made payments of cumulative interest in the year 1936 by giving negotiable notes to the stockholders; in 1937 payment was made in cash as interest. Books, accounts, information returns, corporate tax returns, minutes of meetings and letters to stockholders all considered the payments to be interest payments and interest was calculated from date of issue, instead of from date of declaration. It was further shown that the holders of preferred stock had no voice in the affairs of the corporation and that all of the preferred stock was subject to redemption and discharge.

5. The construction and enforcement attempted to be given Section 26 (c)(1) of the 1936 Revenue Act by the Commissioner would bring about illegal discrimination and a denial of equal justice to persons in similar circumstances, contrary to the 5th, 14th and 16th Amendments to the Constitution of the United States, as well as the Louisiana Constitution.

The main questions might be summarized and condensed as:

What is a contract? and What is interest?

[fol. 108] IV. Assignment of Errors

The appellant assigns as errors the following acts and omissions of the Tax Court of the United States:

1. The Tax Court erred in holding that the provisions prohibiting dividends in the charter and stock certificates of Hercules Gasoline Company, Inc., did not constitute a written contract executed by the corporation.

2. The Tax Court erred in holding that the petitioner had failed to prove inability to pay any dividends in 1937.

3. The Tax Court erred in holding that the Commissioner was not estopped to contend that the charter and stock certificate provisions prohibiting the payment of dividends on common stock until all of the preferred stock had been retired, inasmuch as the same issue was involved in the 1936 return for which the Commissioner gave credit.

4. The Tax Court erred in holding that the transferee's tax liability for 1936, under the contract provisions, was a

different cause of action from the present controversy and that the credit allowed in 1936 did not include the entire preferred stock outstanding.

5. The Tax Court erred in finding that the payments made by transferor corporation to its preferred stockholders were not interest payments.

6. The Tax Court erred in following its own decision in Senior Investment Corporation and declining to adopt the legal precedent established in Lehigh Structural Steel Company (127 F. (2nd) 67) decided by the United States Circuit Court of Appeals for the Third Circuit.

[fol. 109] 7. The Tax Court erred in failing to find that the construction and enforcement given Section 26 (c)(1) of the 1936 Revenue Act by the Commissioner was arbitrary and discriminatory.

8. The Tax Court erred in the making and entry of its decision and order of July 31, 1944, for the reason that judgment is contrary to the law and the evidence.

The appellant herein being aggrieved by said decision of the Tax Court of the United States and by the said errors and omissions heretofore referred to desires to obtain a review of said decision and of all the proceedings heretofore had before the Tax Court of the United States, by the United States Circuit Court of Appeals for the Fifth Circuit, to the end that the errors and omissions of the Tax Court of the United States be corrected and that the decision of the Tax Court of the United States be reversed; and, in the alternative, appellant prays that the case be remanded to the Tax Court on the plea of estoppel and for further evidence on the question of identity of issues involved in the 1936 and 1937 tax liability and what constituted the dividends paid credit in the 1936 tax settlement; that the appellant be relieved of any deficiency growing out of the errors complained of.

(Sgd.) Melvin F. Johnson, Attorney for Petitioner.

1026 Giddens-Lane Building, Shreveport 4, Louisiana.

Duly sworn to by Melvin F. Johnson. Jurat omitted in printing.

[fol. 110] IN UNITED STATES CIRCUIT COURT OF APPEALS

NOTICE OF FILING PETITION FOR REVIEW—Filed September 30, 1944

To: J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent:

Please take notice that the appellant, Hercules Gasoline Company, Inc., on the 28th day of September, 1944, filed with the Clerk of the Tax Court of the United States at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Fifth Circuit, of the decision of the Tax Court heretofore entered on July 31, 1944, in the above entitled cause.

A copy of the petition for review and the assignments of errors, as filed, is hereto attached and served upon you dated this 28th day of September, 1944.

Melvin F. Johnson, Attorney for Petitioner-Appellant.

[fol. 111] Personal service of the foregoing notice, together with a copy of the petition for review and assignments of errors is hereby acknowledged this 29th day of September, 1944.

(Sgd.) J. P. Wenchel (C. A. R.), Chief Counsel, Bureau of Internal Revenue, Counsel for Respondent-Appellee.

IN THE TAX COURT OF THE UNITED STATES

PRAECIPE FOR RECORD—Received October 9, 1944,

Filed September 28, 1944

To the Clerk of the Tax Court of the United States:

You are hereby requested to prepare and certify and transmit to the Clerk of the United States Circuit Court of Appeals for the Fifth Circuit, with reference to the petition for review heretofore filed by the appellant in the above entitled cause, a transcription of the record in the above entitled cause prepared and transmitted as required by law and by the rules of said Court and to include in

said transcript of record the following documents or certified copies thereof, to-wit:

1. The docket entries of all proceedings before the Tax Court of the United States in the above entitled cause.

2. Pleadings before the Tax Court of the United States as follows:

a. Petition for redetermination with attached notice of deficiency.

[fol. 112] b. Respondent's answer.

c. Plea of Res Adjudicata.

d. Plea of Unconstitutionality.

3. The testimony taken before the Tax Court December 7, 1943.

4. The exhibits filed, same to be sent up in the original.

5. Memorandum findings of fact and opinion by the Tax Court dated July 31, 1944.

6. Decision of the Tax Court of the United States entered July 31, 1944.

7. Petition for review filed by the appellant in the above entitled cause and Notice of Filing with acknowledgment of service.

8. This Praecipe.

(Sgd.) Melvin F. Johnson, Attorney for Appellant.

Personal service of a copy of the foregoing Praecipe is hereby acknowledged this 29th day of September, 1944.

(Sgd.) J. P. Wenchel, C. A. R., Chief Counsel, Bureau of Internal Revenue, Attorney for Appellee.

The Tax Court of the United States. Filed Sep. 29, 1944.

[fol. 113] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 114] That thereafter the following proceedings were had in said cause in the United States Circuit Court of Appeals for the Fifth Circuit, viz:

ARGUMENT AND SUBMISSION

Extract from the Minutes of January 29th, 1945

No. 11211

HERCULES GASOLINE COMPANY, INC.

versus

COMMISSIONER OF INTERNAL REVENUE

On this day this cause was called, and, after argument by Melvin F. Johnson, Esq., for petitioner, and Mrs. Maryhelen Wigle, Special Assistant to the Attorney General, for respondent, was submitted to the Court.

[fol. 115] OPINION OF THE COURT AND DISSENTING OPINION OF HUTCHESON, CIRCUIT JUDGE—Filed March 1, 1945

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 11211

HERCULES GASOLINE COMPANY, INC., Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent

Petitioner for Review of Decision of the Tax Court of the United States (District of Louisiana)

(March 1, 1945)

Before Hutcheson Holmes, and McCord, Circuit Judges

HOLMES, Circuit Judge:

Section 26(c)(1) of the Revenue Act of 1936 relieves corporations from taxes upon undistributed profits to the extent that such profits could not be distributed without vio-

lating a provision of a written contract executed by the cor-
[fol. 116] poration prior to May 1, 1936, which provision expressly dealt with the payment of dividends. Petitioner's transferor, prior to May 1, 1936, issued preferred-stock certificates, and incorporated therein by reference an article of its charter providing that no dividend should be paid on the common stock of the corporation until all the preferred stock had been redeemed and retired. The certificates provided for cumulative dividends, at 8% per annum, payable whenever declared out of surplus net profits.

The two principal issues presented are (1) whether the preferred-stock certificates were contracts within the purview of Section 26(c)(1), *supra*, and (2) whether the corporation could deduct, as interest, the dividends paid on the preferred stock during the tax years.

The second question requires little comment. The mere fact that some of the shares were issued to creditors in payment of corporate debts does not serve to convert dividends into interest. The respective terms have acquired definite meanings. Interest is a fixed percentage premium paid on a time basis for the use or detention of money. It becomes a debt merely upon the passing of time, either by the terms of the primary obligation or by operation of law. A dividend, on the contrary, does not become a debt until profits have been earned and a declaration of dividends is made. It is a distribution of profits to adventurers in a common enterprise.[1] Here the corporate debtors became corporate stockholders by accepting stock, and the distributions to them were dividends declared from profits rather than payments upon corporate debts.[2] Such distributions were not deductible as interest.

The solution to the other question is not so plain. Section 26(c)(1) has been construed in parallel or closely re-

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[1] The distinction is clearly drawn in Warren v. King, 108 U. S. 389.

[2] The allowance of a deduction under Section 23(b) of the Revenue Act of 1936 is only with respect to interest paid or accrued within the taxable year *on indebtedness*.

[fol. 117] lated cases in several other circuits,[3] but with so balanced a divergence of opinion that those decisions are not particularly helpful. We think the reasoning and pronouncements of the Supreme Court in the leading case of *Helvering v. Northwest Steel Mills*, 311 U. S. 46, when analyzed and applied to the facts present here, require an affirmance of the Tax Court's decision disallowing the credit.

While the precise question in the *Northwest Steel Mills* case was whether the provisions of a state statute could be read into a corporate charter so as to form a contract containing the restrictive provision required by Section 26(c)(1), much of what was said is applicable here where we are concerned with the provisions of stock certificates containing by reference certain charter provisions. The court in the *Steel Mills* case, construing the statute strictly, held that the prohibition against dividend payments must be expressly written in the executed contract, and could not be incorporated therein by reference, implication, or otherwise. Here the share certificates, upon which complete reliance is placed, did not include the prohibition other than by reference to the charter. The court's opinion also has been construed to hold that a corporate charter, though it contains the formal requisites of a contract, is not such a contract as was contemplated by Congress in the enactment of the statute.[4] It may be that the very question before us was decided adversely to the taxpayer in the *Northwest Steel Mills* case, as footnote 17 of the opinion recites: "Respondent contended that the stock certificates satisfied the statutory requisites even if the charter did not; but what we have here said with respect to the charter applies equally to the certificates." [fol. 118] The holding of the opinion that we find most

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[3] Lehigh S. S. Co. v. Commissioner, 127 F. (2) 67; Metal Specialty Co. v. Commissioner, 128 F. (2) 259; Warren Tel. Co. v. Commissioner, 128 F. (2) 503; Elliott Addressing Machine Co. v. Commissioner, 131 F. (2) 700; Monarch Theatres v. Helvering, 137 F. (2) 588; Rex-Harrover Mills Co. v. United States, 53 Fed. Supp. 235.

[4] Warren Tel. Co. v. Commissioner, 128 F. (2) 503.

persuasive, however, is that the credit was intended to apply only to corporations contractually obligated to set earnings aside for the *payment of debts*. The shareholders of a corporation are not its creditors; they are its owners. As the court said in *Warren v. King*, 108 U. S. 389, 399:

> "Whatever position the holders of preferred certificates occupied before they accepted preferred stock, whatever special rights of lien they had, they became corporators, proprietors, shareholders, and abandoned the position of creditors, and took up toward existing and future creditors the same position which every stockholder in a corporation occupies toward existing and future creditors. His chance of gain, by the operations of the corporation, throws on him, as respects creditors, the entire risk of the loss of his share of the capital, which must go to satisfy the creditors in case of misfortune. He cannot be both creditor and debtor, by virtue of his ownership of stock."

We are therefore of the opinion that the stock certificates were not contracts within the provisions of Section 26(c)(1). The minor contentions that the 1937 settlement was *res judicata*, and that petitioner's transferor was a deficit corporation, are without foundation in the record, and the decision of the Tax Court is affirmed.

HUTCHESON, *Circuit Judge*, Dissenting:

I dissent from the conclusion of the majority that the Taxpayer is not entitled to the credit it claimed. I particularly dissent from the reasoning on which that conclusion was based. As I understand the opinion, it is [fol. 119] bottomed on a dictum contained in an opinion of the Supreme Court which decided an entirely different question arising on an entirely different set of facts from that presented here. I recognize, of course, that the rule of *stare decisis* binds us to follow that court in respect of things decided by it. I know of no rule of *stare dictis* which binds us to follow it in respect of things merely said by it. Indeed, I understand the rule as established in our law to be quite the contrary. It is true that some of the federal courts, the Sixth Circuit in a modified, the

First Circuit [1] in an all out way, have, in the role of crystal gazers, laid claim to a prescience, indeed a clairvoyance as to judicial things to come, commonly not supposed to be required equipment for the task of judging. Other courts, notably the Third Circuit,[2] the Court of Claims,[3] and the Second Circuit,[4] following the established rule that what is decided, not what is said by the Supreme Court, binds, have taken a different view of their obligation to foretell what next that court may decide. All that was decided in the *N. W. Steel Mills* case was that to entitle to the credit there must be a written contract executed by the corporation which expressly deals with the payment of dividends and that there was no such contract exhibited but only a statute prohibiting deficit corporations from paying dividends.[5] There is no question here of a prohibitory [fol. 120] law. What prevents the payment of dividends here is an express and binding contract evidenced by the stock certificates completely and entirely forbidding the payment of dividends. It is settled in this circuit [6] and in

[1] In Elliott v. Comm., 131 F. (2) 700, that court, without explaining how the Supreme Court could, without legislating, have gone farther than the specified facts of the case entitled them to go, said: "From our reading of Helvering v. N. W. Steel Mills, 311 U. S. 46, we are of the opinion that the court intended to go farther than the specified facts in that case."

[2] Lehigh S. S. Co. v. Comm., 127 F. (2) 67; Budd v. Comm., 143 F. (2) 784, certiorari denied.

[3] Rex Hanover Mills v. U. S., 53 Fed. Sup. 235.

[4] Monarch Theater v. Helvering, 137 F. (2) 588. In that case the court said: "The often quoted language of Mr. Justice Black in Helvering v. N. W. Steel Rolling Mills * * * was used discursively and by way of example; it is not to be understood as laying down absolute doctrine."

[5] The Court said: "What prohibited respondent from distributing dividends was not the provision of an executed written contract expressly dealing with the payment of dividends. On the contrary, what prohibited respondent from paying dividends was a valid law of the State of Washington." 311 U. S. page 52.

[6] Sabine Co. v. Comm., 128 F. (2) 945.

the Supreme Court,[7] as we said of a companion section in

[7] Helvering v. Credit Alliance Co., 316 U. S. 107.

American Liberty Pipe Line Co. v. Comm., 143 F. (2) 873:

> "* * * wherever this section and its companion, the dividends paid credit section, have been up for decision, the courts have made it plain, as well where such construction advantaged, as where it disadvantaged, the taxpayer, that the statute is plainly and clearly written, and that it must be applied as written. It may not be enlarged or restricted by a construction which, under the guise of giving effect to its supposed intent and purpose, adds to or takes away from its terms."

The application of that principle of construction here leaves in no doubt, I think, that the taxpayer was entitled to the credit that he claimed, and that the judgment of the Tax Court was wrong. I dissent from its affirmance.

[fol. 121] JUDGMENT

Extract from the Minutes of March 1st, 1945

No. 11211

HERCULES GASOLINE COMPANY, INC.,

versus

COMMISSIONER OF INTERNAL REVENUE

This cause came on to be heard on the petition of Hercules Gasoline Company, Inc., for a review of a decision of The Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court, that the decision of the said Tax Court of the United States in this cause be, and the same is hereby, affirmed.

"Hutcheson, Circuit Judge, dissents."

[fol. 122] IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

[Title omitted]

PETITION FOR REHEARING—Filed March 15, 1945

To the Honorable Fifth United States Circuit Court of Appeals:

Comes now Hercules Gasoline Company, Inc., the appellant in the above-entitled cause, and presents this, its petition, for a rehearing of the above-entitled cause, and, in support thereof, with respect shows:

1

This Court erred in its decision and judgment rendered on March 1, 1945, in holding that the taxpayer is not entitled to the contract credit.

[fol. 123]

2

This Court erred in holding that *Helvering v. Northwest Steel Mills, 311 U. S. 46*, applied to the facts present here.

3

This Court erred in finding that the said Steel Mills case ruled that the prohibition against dividend payments must be expressly written in the executed contract and could not be incorporated therein by reference.

4

This Court erred in holding that the credit applied only to corporations contractually obligated to set earnings aside for the payment of debts.

5

This Court erred in stating inferentialally that the preferred stockholders of Hercules Gasoline Company, Inc., were owners of the corporation.

This Court erred in affirming the judgment of the Tax Court and by assuming that petitioner ever claimed that it or its transferror was a deficit corporation.

Wherefore, upon the foregoing grounds, it is respectfully urged that this petition for a rehearing be granted [fol. 124] and that the judgment of the Tax Court be upon further consideration reversed.

Respectfully submitted, Melvin F. Johnson, 1026 Giddens-Lane Bldg., Shreveport 4, Louisiana, Attorney for Appellant, Hercules Gasoline Company, Inc.

CERTIFICATE OF COUNSEL

I, counsel for the above named appellant, do hereby certify that the foregoing petition for a rehearing of this cause is presented in good faith and not for delay.

Melvin F. Johnson, Counsel for Hercules Gasoline Company, Inc., Appellant.

[fol. 125] ORDER DENYING REHEARING

Extract from the Minutes of April 19th, 1945

No. 11211

HERCULES GASOLINE COMPANY, INC.,

versus

COMMISSIONER OF INTERNAL REVENUE

It is ordered by the Court that the petition for rehearing filed in this cause be, and the same is hereby, denied.

[fol. 126] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 127] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed October 8, 1945

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit is granted, and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Jackson and Mr. Justice Burton took no part in the consideration or decision of this application.

Endorsed on Cover: File No. 49,775. U. S. Circuit Court of Appeals, Fifth Circuit. Term No. 93. Hercules Gasoline Company, Inc., Pettiioner, vs. Commissioner of Internal Revenue. Petition for a writ of certiorari and exhibit thereto. Filed May 28, 1945. Term No. 93 O. T. 1945.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 1322 93

HERCULES GASOLINE COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

MELVIN F. JOHNSON,
Counsel for Petitioner,
JOSEPH H. JACKSON,
Of Counsel for Petitioner.

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MISCELLANEOUS CITATIONS

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 1322

HERCULES GASOLINE COMPANY, INC.,
Petitioner and Appellant Below,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent and Appellee Below.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

To the Honorable Harlan Fiske Stone, Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Your petitioner respectfully shows:

I

Summary Statement of the Matter Involved

Section 26 (c) (1) of the Revenue Act of 1936 (26 U. S. C. A. Int. Rev. Acts, page 836) relieves corporations from surtaxes upon undistributed profits to the extent that such

profits could not be distributed without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends.

Petitioners transferror (a Louisiana corporation of the same name), prior to May 1, 1936, issued preferred stock certificates and incorporated therein by reference an article of its charter providing that no dividend should be paid on the common stock of the corporation until all of the preferred stock had been retired, redeemed and discharged.

The Commissioner of Internal Revenue gave notice of deficiency in income and excess profits tax for 1937, in which he claimed a surtax on undistributed profits amounting to $32,481.53 (R. 25). Appellant filed petition to the Tax Court of the United States (R. 3), seeking a redetermination of its tax liabilities, alleging that the corporation was entitled to credit against this surtax, levied against undistributed profits by Sec. 14 of the law of 1936, by virtue of a contract between the corporation and the holders of its preferred stock which satisfied the requirements for credit under Sec. 26 (c) (1) of the tax statute. After trial, the Tax Court entered its decision upholding the Commissioner (R. 92). Petition for review was filed with the Fifth Circuit Court of Appeals, which affirmed the decision of the Tax Court, March 1, 1945 (R. 114). Thereafter, petition for rehearing was denied April 19, 1945 (R. 123).

II

Question Presented

The question presented is whether provisions in a corporate charter and stock certificates prohibiting the payment of dividends constitute a written contract executed by the corporation, for which the corporation is entitled to

credit against a surtax on corporate profits under Sec. 26 (c) (1) of the Revenue Act of 1936.

III

Reasons Relied On for the Allowance of the Writ

The decision of the Circuit Court of Appeals for the Fifth Circuit (R. 114), as to whether provisions in a charter and stock certificate constitute a written contract executed by the corporation is in conflict with the decision of the Circuit Court of Appeals for the Third Circuit on the same matter in the case of *Lehigh Structural Steel Company* v. *Commissioner*, 127 F. (2nd) 67.

The decision of the Circuit Court of Appeals for the Fifth Circuit on this matter is likewise in conflict with the decision of the Court of Claims on the same matter in the case of *Rex Hanover Mills* v. *U. S.*, 53 Fed. Sup. 235 and with the decision of the Circuit Court of Appeals for the Second Circuit on the same matter in the case of *Monarch Theatres* v. *Helvering*, 137 F. (2nd) 588.

IV

Jurisdictional Statement

Therefore, because of these conflicting decisions of the Circuit Courts which should be made uniform, jurisdiction is invoked under Section 240 (a) of the Judicial Code, as amended (28 U. S. C. A. 347 (a)).

V

Your petitioner presents to this Court and files herewith as an exhibit hereto and part hereof, a duly certified transcript of the entire record in the case as the same appears in the United States Circuit Court of Appeals.

WHEREFORE, your petitioner prays that a writ of certiorari issue under the seal of this Court, directed to the Circuit Court of Appeals for the Fifth Circuit commanding said Court to send to this Court a full and complete transcript of the record and of the proceedings of said Court had in the case numbered and entitled on the Docket No. 11,211, Hercules Gasoline Company, Inc., Petitioner, vs. Commissioner of Internal Revenue, Respondent, to the end that this cause may be reviewed and determined by this Court as provided for by the statutes of the United States; and that the judgment herein of said United States Circuit Court of Appeals for the Fifth Circuit be reversed by this Court and for such further relief as to this Court may seem proper.

Dated May —, 1945.

MELVIN F. JOHNSON,
1026 Giddens-Lane Bldg.,
Shreveport 4, Louisiana,
Counsel for Petitioner.

JOSEPH H. JACKSON,
1030 Giddens-Lane Bldg.,
Shreveport 4, Louisiana,
Of Counsel.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 1322

HERCULES GASOLINE COMPANY, INC.,
Petitioner and Appellant Below,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent and Appellee Below

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

To the Honorable the Supreme Court of the United States:

Your petitioner respectfully shows:

I

Opinions Below

The opinion of the Tax Court of the United States will be found at pages 92-102, inclusive, of the record herein.

The opinion and judgment of the United States Circuit Court of Appeals for the Fifth Circuit, including the dissenting opinion of Circuit Judge Hutcheson, is included in

the transcript of the record of that Court, attached hereto pages 114-119 inclusive. It is reported in 147 F. (2d) 972.

II

Jurisdiction

1. The date of the final decree of the said Fifth Circuit Court, in the case to be reviewed herein, is April 19, 1945 (R. 123).

2. The statutory provision which is believed to sustain the jurisdiction of this Court is c. 517, Sec. 6, 26 Stat. 828 as amended (28 U. S. C. A., Sec. 347, Judicial Code, Sec. 240, amended):

> "(a) In any case, civil or criminal, in a circuit court of appeals, or in the Court of Appeals of the District of Columbia, it shall be competent for the Supreme Court of the United States, upon the petition of any party thereto, whether Government or other litigant, to require by certiorari, either before or after a judgment or decree by such lower court, that the cause be certified to the Supreme Court for determination by it with the same power and authority, and with like effect, as if the cause had been brought there by unrestricted writ of error or appeal.
>
> "(b) Any case in a circuit court of appeals where is drawn in question the validity of a statute of any State, on the ground of its being repugnant to the Constitution, treaties, or laws of the United States, and the decision is against its validity, may, at the election of the party relying on such State statute, be taken to the Supreme Court for review on writ of error or appeal; but in that event a review on certiorari shall not be allowed at the instance of such party, and the review on such writ of error or appeal shall be restricted to an examination and decision of the Federal questions presented in the case.

"(c) No judgment or decree of a circuit court of appeals or of the Court of Appeals of the District of Columbia shall be subject to review by the Supreme Court otherwise than as provided in this section. (Mar. 3, 1891, c. 517, Sec. 6, 26 Stat. 828; Mar. 3, 1911, c. 231, Sec. 240, 36 Stat. 1157; Feb. 13, 1925, c. 229, Sec. 1, 43 Stat. 938.)"

3. Facts, nature of the case and ruling of the courts below bringing the case within the jurisdiction provision above quoted has already been stated in the preceding petition under I (page 1) which is hereby adopted and made a part of this brief.

III

Statement

1. The corporation had a provision in its charter, which was brought into the preferred stock certificates by specific reference, reading as follows: "The common stock shall be subject to the prior rights of the holders of the preferred stock as above declared and there shall be no dividend on the common stock until all of the preferred stock has been retired, redeemed and discharged." (R. 9). The corporation, in 1933 and 1935 had issued and in 1937 had outstanding 1294 shares of the par value of $50 per share, the total issue thus being $64,700. There is no dispute as to the facts, no contest as to transferee liability no denial concerning the issue of this stock, nor that it was issued prior to May 1, 1936 or that it expressly deals with the payment of dividends. The Commissioner first raised the point in his 90 day letter that the preferred stock certificates do not constitute a "written contract" within the meaning of Sec. 26 (c) (1) of The Revenue Act of 1936 (R. 23).

2. Act 250 of the Legislature of Louisiana of 1928, Sec. 14, specifically authorizes rights and restrictions concerning

preferred stock to be incorporated into the certificates by reference to the charter. The taxpayer observed this law by referring to the charter in both the preferred and common stock certificates. The preferred stockholders were different from the common stockholders.

3. The Tax Court sustained the Commissioner and held that these facts do not amount to "a written contract executed by the corporation" restricting the payment of dividends within the meaning of Sec. 26-(c) (1) of The Revenue Act of 1936 (R. 99-100).

4. The U. S. Circuit Court of Appeals for the Fifth Circuit affirmed the Tax Court, disallowing the credit claimed under the contract restriction (R. 114 et seq.), giving a different basis for decision than had the Tax Court. The Circuit Court gave as its opinion that the question had been answered by this Court in the case of *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46. In a strong dissenting opinion, Circuit Judge Hutcheson criticized the majority opinion and stated that he thought the taxpayer herein was entitled to the credit he claimed and that the judgment of The Tax Court was wrong (R. 117-119).

5. The Circuit Court of Appeals for the Third Circuit in 1942, 127 F. (2nd) 67, concluded that stock certificates containing similar provisions to those issued by Hercules Gasoline Company did evidence a contract between the parties. See also the decision of the same court in *Budd* v. *Commissioner*, 143 F. (2nd) 784.

6. In similar and closely related cases in the Court of Claims (*Rex Hanover Mills* v. *U. S.*, 53 Fed. Sup. 235) and the Second Circuit Court (*Monarch Theatres* v. *Helvering*, 137 F. (2nd) 588), the courts decided contrary to the Fifth Circuit Court ruling in the present case and thus there is what very plainly appears to be a conflict between decisions

of the Circuit Courts and other Federal Courts which this court should review and reconcile to the ends of justice and uniformity.

IV

Statute Involved

1. The Revenue Act of 1936 (26 U. S. C. A. Int. Rev. Acts, page 835) levied a surtax on undistributed profits commencing at 7% and going to 27% on the adjusted net income. Section 26 of this Act allows certain credits against the tax, as follows:

Sec. 26. Credits of Corporations:

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * * *

(c) Contracts Restricting Payment of Dividends.

(1) Prohibition on payment of dividends. An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) Disposition of profits of taxable year. An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with

the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) Double credit not allowed. If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

* * * * * * * *

V

Specification of Errors

The Fifth U. S. Circuit Court of Appeals erred:

1. In holding that the provisions prohibiting dividends in the charter and stock certificates of petitioner, Hercules Gasoline Co., Inc., do not constitute a written contract executed by the corporation.

2. In holding that Your Honors in *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, were intending to decide that provisions in stock certificates were not written contracts executed by the corporation within the meaning of this statute.

3. In holding that 26 (c) (1) requires that the credit against undistributed profits only applies to corporations contractually obligated to set earnings aside for the payment of debts (Sec. 26 (c) (2)).

VI

Reasons for Granting the Writ

1. It will thus be seen that this is strictly a legal question involving the meaning of the words "written contract executed by the corporation" in the 1936 Act. The facts in the present case are almost identical with the facts involved in the cases decided by other Circuit Courts, as to the construction of the words "contract executed by the corporation." The meaning of the language used and the principles laid down by this Court in the principal case of *Northwest Steel Mills* case, decided in 1940, also is a matter about which these courts cannot agree.

2. The Fifth Circuit Court held that to entitle a corporation to the credit it was necessary that the contract concern the setting aside of earnings toward the payment of debts. Of course, this construction of the law is wrong because petitioner is relying on Sec. 26 (c) (1) of the statute quoted above which allows credit for prohibition in a contract made by the corporation with anyone. It is Sec. 26 (c) (2) which allows credit for contracts with creditors of the corporation for the setting aside of earnings toward the payment of debts.

3. The decision of Your Honors in the *Northwest Steel Rolling Mills* case was a legal precedent to the extent only of deciding that to entitle a corporation to the credit there must be a written contract executed by the corporation which expressly deals with the payment of dividends. There was no such contract exhibited by the taxpayer corporation in that case, where reliance was upon the provisions of the law of the State of Washington, prohibiting deficit corporations from paying dividends.

4. The Third Circuit Court, on the other hand, has held provisions in stock certificates providing for a sinking fund for the retirement of prefererd stock legally constituted a "contract" between the holders of stock certificates and the corporation issuing them and gave petitioning corporations credit under the law.

Where amendment of Delaware corporation charter, accepted by stockholders and filed with Secretary of State of Delaware provided for sinking fund for retirement of preferred stock by setting aside percentage of net earnings after payment of preferred dividends and before paying other dividends, and such provision was set out in preferred stock certificates, corporation in determining undistributed profits surtax was entitled to credit for so much of profits, as corporation paid into sinking fund on ground that each certificate constituted a "contract" within statute authorizing credit for surtax purposes for profits which corporation could not distribute as dividends without violating written contract executed by corporation. Revenue Act 1936, Secs. 14, 26 (c) (1), 26 U. S. C. A. Int. Rev. Acts, pages 823, 836.

Lehigh Structural Steel Co. v. *Commissioner*, 127 F. (2nd) 67.

Where amended articles of incorporation and preferred stock certificates prohibited corporate taxpayer from paying dividends to holders of common stock until payment into sinking fund annually of an amount equal to 3 per cent. of the preferred stock, there was a "written contract executed by corporation" expressly dealing with payment of dividends which entitled taxpayer to credit to extent of sinking fund payment in computing undistributed net income. Revenue Act of 1936, Secs. 14, 26 U. S. C. A. Int. Rev. Acts, page 823.

Budd International Corporation v. *Commissioner*, 143 F. (2nd) 784.

Agreement of corporation printed on preferred stock certificates issued in 1933 requiring corporation to pro-

vide a sinking fund before payment of dividends on any class of stock other than preferred stock constituted a "written contract executed by corporation" restricting payment of dividends within statute authorizing credit for surtax purposes for profits which corporation cannot distribute as dividends without violating such a contract. Revenue Act 1936, Secs. 14, 26 (c) (1), 26 U. S. C. A. Int. Rev. Acts, pages 823, 836.

Rex-Hanover Mills Co. v. *Commissioner*, 53 F. Supp. 235.

"It is therefore, settled in this circuit that restrictive provisions in a corporate charter, by-laws and certificates of stock as are present in the instant matter, constitute a written contract within Section 26 (c) (1) of the 1936 Revenue Act."

Philadelphia Record Co. v. *Commissioner*, 145 F. (2nd) 613.

Also see:

Eljer Co. v. *Commissioner*, 134 F. (2nd) 251.
Monarch Theatres, Inc. v. *Commissioner*, 137 F. (2nd) 588.

VII

Conclusion

A confusion and diversity has arisen. We beg the Court to consider the conflict concerning this Federal Statute which clearly exists among the Circuit Courts of Appeal on the plain question whether stock certificates containing a prohibition against the payment of dividends legally constitute a written contract executed by the corporation. Of course, the legal consequences of this conflict are that some citizens are required to pay the tax and others are relieved; some courts hold that the relationship of stockholder-corporation is not a contractual relationship and other courts hold directly to the contrary, some courts hold that Congress intended a certain kind of contract (which Congress did not

define) and other courts hold that the words used by Congress should be given their plain meaning and should be applied as written.

Therefore, under the law and the Rules of this Court (Rule 38(5)(b)) we submit that this case is one calling for the exercise by this Court of its supervisory powers by granting a Writ of Certiorari to the Fifth Circuit Court, that the decision complained against may be reviewed and determined according to law and the decisions pertaining to this question be resolved and made uniform throughout the United States.

Respectfully submitted,

MELVIN F. JOHNSON,
Attorney for Petitioner,
Hercules Gasoline Co., Inc.
JOSEPH H. JACKSON,
Attorney of Counsel for Petitioner.

May, 1945.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945

No. 93

HERCULES GASOLINE COMPANY, INC.,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certionari to the United States Circuit Court of Appeals for the Fifth Circuit.

REPLY BRIEF FOR PETITIONER.

MELVIN F. JOHNSON,
Counsel for Petitioner;

JOSEPH H. JACKSON,
Of Counsel for Petitioner.

August, 1945.

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SUPREME COURT OF THE UNITED STATES

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On Petition for a Writ of Certionari to the United States Circuit Court of Appeals for the Fifth Circuit.

REPLY BRIEF FOR PETITIONER.

When analyzed, the brief in opposition for the Respondent, the Commissioner of Internal Revenue, does not meet the proposition presented in petitioner's application and brief for the writ of certiorari.

In the petition for review of this case, petitioner sets forth the conflict between the decision of the Fifth Circuit Court of Appeals, of which review is sought, with the several decisions of the Third Circuit Court of Appeals and other Federal court decisions. In opposing

petitioner's application, Respondent argues that this case does not warrant further review because "it was correctly decided in accordance with principles enunciated by this Court in Helvering v. Northwest Steel Mills, 311 U. S. 46, and the statutory provision involved has been superseded". This argument is unsound and illogical because the first point is a hasty generalization on insufficient data and is assumed by Respondent, through mistake and error, and the second point, although true, constitutes no reason for denying review.

1.

Respondent fails to show any reason why the writ should not be granted in this case by the contention that the decision is in accordance with the Northwest Steel Mills case.

Respondent is making the same mistake that a number of Judges and Courts have made with reference to Your Honors' decision in *Helvering v. Northwest Steel Mills.* He quotes from *dictum* instead of opinion. Your decision was, primarily, an interpretation of Sec. 26 (c) (1) of the 1936 Revenue Act. In concluding that the law does not authorize a credit when applied to statutorily prohibited dividends, this Court thought such construction of Sec. 26 (c) (1) was supported by a consideration of Sec. 26 (c) (2). It was of Sec. 26 (c) (2) that the Court said "this section referred to routine contracts dealing with ordinary debts." If Respondent had not fallen into this palpable error, he would quote correctly

from your decision in referring to Sec. 26 (c) (1), where Your Honors put the matter in this way:

> "The natural impression conveyed by the words 'written contract executed by the corporation' is that an explicit understanding has been reached, reduced to writing, signed and delivered."

The certificates of stock of Hercules Gasoline Company, Inc., were signed by the President and Secretary, they contained by specific reference to the charter the dividend prohibition which the record shows was an explicit understanding and they were delivered to and accepted by the preferred stockholders. It would seem, to the contrary of Respondent's argument, more logical to say that the subject case should be reviewed and uniformity established.

Thus, it is improper and illogical to say that the Fifth Circuit Court in the present case decided the contract question involved here in accordance with the principles enunciated by this Court in *Helvering v. Northwest Steel Mills* and as a consequence this Court should decline to reconcile the decisions because the conflict admittedly exists among the circuits as to the meaning of the *Northwest Steel* case,—or whether it applies at all to the issue herein.

The Northwest Steel Mills case did not decide whether stock certificates forbidding payment of dividends constituted a binding contract under this section of the law because that was not an issue to be decided in the case. Here is the first presentation of this legal proposition to this Court.

The expression of this Court, so often quoted by courts, ("routine contracts", etc.) was referring to 26 (c) (2) of the 1936 Revenue Act. This section gives credit to a corporation required to set earnings aside to pay its creditors. Of course, it is so plain that "He who runs may read" that 26 (c) (1) applies to any restrictive "contract" made by a corporation with anyone, whether or not he is a creditor of the corporation. (See original Brief with petition, pages 9-10).

Judge Hutcheson, in his dissenting opinion (R. 117-119 in the present case, clearly demonstrates that this case was not decided by the Fifth Circuit in accordance with the principles enunciated in the *Northwest Steel Mills* case because, as he points out, the majority of his court bottomed their reasoning on a *dictum* contained in the *Northwest Steel Mills* case, "which decided an entirely different question arising on an entirely different set of facts from that presented here" and Judge Hutcheson states the existing conflict of decisions with much more brevity and erudition than we can state it. It is clear that he looks ahead to a clarifying decision by this Court.

2.

The Respondent fails to show that review should not be granted by argument that the law involved has been superseded.

In this connection, the Respondent's Brief in opposition, admitting that there is a divergency of opinion to resolve, makes the argument seriously that since the revenue laws no longer contain provisions corresponding to

Sec. 26 (c) (1) of the 1936 Act, the number of cases still concerned with that section is consequently unappreciable and suggests, by connotation, that this Court should decline to review.

This is a poor excuse to urge in order to have this Court let the petitioner stew in the injustice of paying an illegal tax. Because there will not be many other cases involving the same point is no sound argument against a review of this case if it presents a reviewable ground. He is disregarding the principle inscribed on the frieze of this Court's dwelling place: "Equal Justice Under Law."

Counsel correctly states that the statute has been superseded, but we submit that this does not constitute any reason why the Court in its discretion should not review the present case if a diversity exists and an injustice is being done. Our right to petition for, or the Court's discretion to grant, the writ is not measured by quantity.

3.

Respondent fails to meet the proposition of review vel non when he goes into the merits of petitioner's case.

The brief in opposition to petitioner's prayer for writ of certiorari in the discretion of this Court, makes the statement that Congress intended to afford the grace of Sec. 26 (c) (1) to corporations which are contractually obligated to set earnings aside for the protection of creditors. In reply to this argument, let us say, firstly, that this constitutes no reason to deny petitioner the writ and,

secondly, that Congress by plain language in its recorded statute referred to the credit being given to *corporations obligated to set earnings aside for the discharge of a debt in Sec. 26 (c) (2)* of the 1936 Act and made no such requirement for the credit in 26 (c) (1) of the same law.

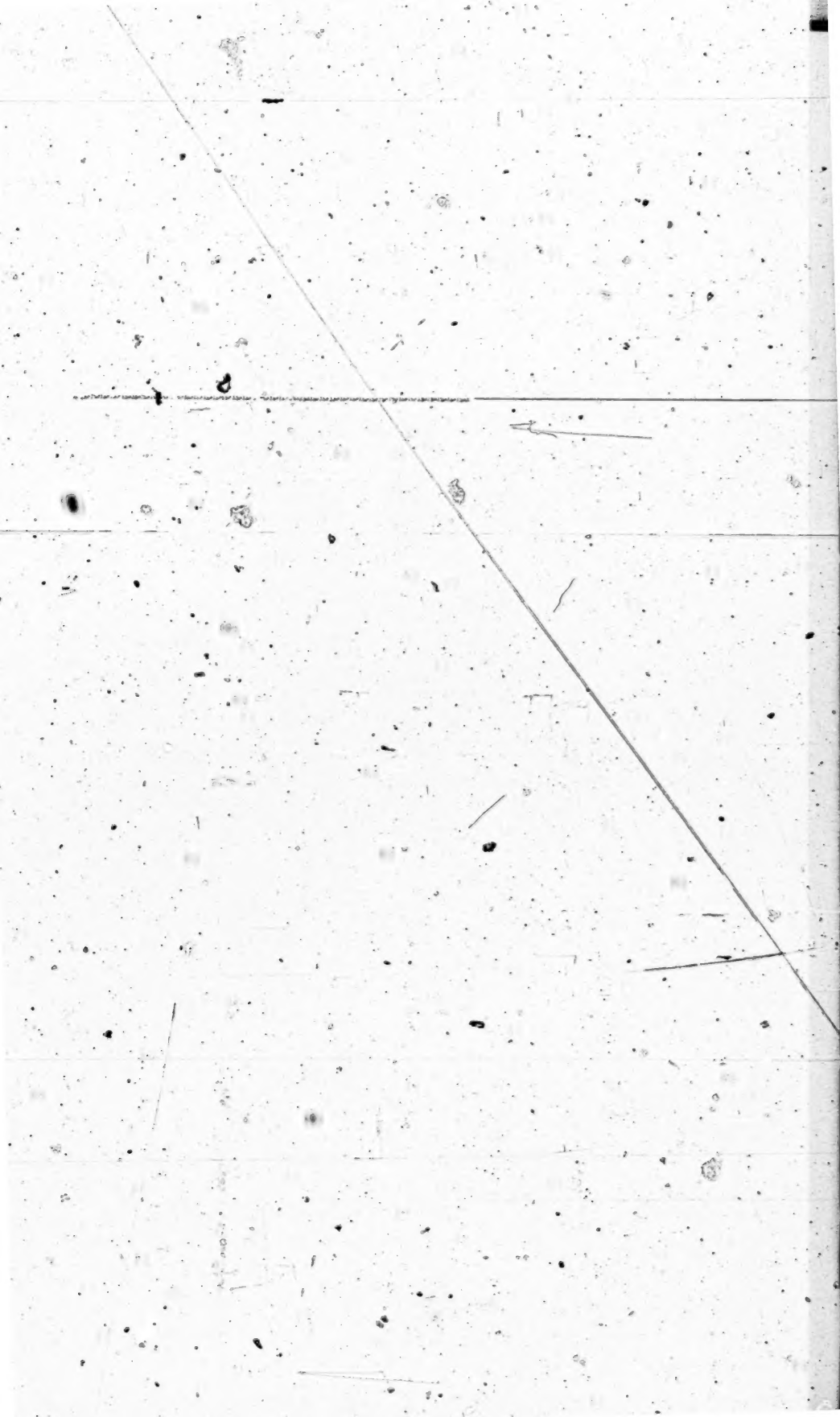
It would seem, in conclusion, that the opposition contains no real reason why the review should not be granted and the divergency of opinion resolved by this Court.

Respectfully submitted,

MELVIN F. JOHNSON,
Counsel for Petitioner;

JOSEPH H. JACKSON,
Of Counsel for Petitioner.

August, 1945.



SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945.

No. 93

HERCULES GASOLINE COMPANY, Inc.,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF FOR PETITIONER.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945.

No. 93

HERCULES GASOLINE COMPANY, Inc.,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF FOR PETITIONER.

This is a proceeding to review a judgment of the Circuit Court of Appeals for the Fifth Circuit involving the undistributed profits tax. The Court granted the petition for writ of certiorari under date of October 8, 1945.

Opinion Below.

The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 81-86) is reported in 147 F. (2d) 972.

Jurisdiction.

The jurisdiction of this Court is invoked under Sec. 240 (a) of the Judicial Code, as amended (28 U.S.C.A. 347 (a)).

Statute Involved.

The statute involved is Sec. 26 of the Revenue Act of 1936, 49 Stat. 1648, 1664 (26 U.S.C.A. Int. Rev. Acts, pages 835-6); the relevant portions of the statute reads as follows:

> Sec. 26. Credits of Corporations:
>
> In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—
>
> * * * * * * *
>
> (c) Contracts Restricting Payment of Dividends.
>
> (1) Prohibition on payment of dividends. An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. . . . Cf. Appendix 29.

Statement of Case.

Hercules Gasoline Company, Inc. was organized in 1933 under the Business Corporation Law of Louisiana (Act 250 of the Legislature of La. for the year 1928). The original charter of the corporation described the kinds, rights, privileges and conditions of the capital stock and expressly provided that there could be no dividend on the common stock until all of the preferred stock had been retired, redeemed and discharged. Every certificate of

stock carried on its face a specific reference to this charter provision. Petitioner maintains that it is entitled to credit against the surtax on corporate profits for the year 1937 because the provisions in the outstanding stock certificates prohibiting the payment of dividends met all requirements of the law for the allowance of the credit.

Facts.

The findings of fact and opinion of the Tax Court are in the Record, pages 64 to 73, inclusive.

The facts are not in dispute and the issues of the controversy have been reduced to the sole question whether provisions in a corporate charter and stock certificates prohibiting the payment of dividends constitute a written contract executed by the corporation for which the corporation is entitled to credit against any surtax on corporate profits under Sec. 26 (c) (1) of the Revenue Act of 1936. The Commissioner of Internal Revenue in 1942 (R. 14) sent to petitioner a notice of deficiency in income tax for the taxable year 1937 in the amount of $32,481.53 as concerns the surtax on undistributed profits (R. 19). The deficiency claimed by the Commissioner grew out of numerous adjustments made by him to the tax return of the corporation for the year in question, principally involving the denial by him of credit against surtax upon undistributed profits. The corporation had taken credit against this surtax by virtue of a contract between the corporation and the holders of its preferred stock.

Hercules Gasoline Company, Inc., the Louisiana corporation, was in existence in 1937, the tax year in-

volved, and was dissolved and liquidated in 1939. Petitioner is a Delaware corporation, organized in 1939, domiciled in Wilmington, and it succeeded as transferee to the assets and liabilities of the La. corporation. Petitioner filed petition to the U. S. Board of Tax Appeals (now the Tax Court of the U. S.) seeking a redetermination of its tax liabilities for the year in question alleging that the Commissioner erred in making each and every one of the adjustments claimed by him. (R. 2-20). After trial, the Tax Court entered its decision upholding the Commissioner (R. 64-73) and the case was appealed to the United States Circuit Court of Appeals for the Fifth Circuit, which affirmed the decision of the Tax Court. (R. 81-86).

The original charter of the La. corporation, drawn and adopted pursuant to Act 250 of Louisiana for the year 1928, contained Article V giving the rights, privileges and conditions of the shareholders. (R. 65-6). Subsection (c) of this article reads as follows:

> (c) The common stock shall be subject to the prior rights of the holders of the preferred stock as above declared and there shall be no dividend on the common stock until all of the preferred stock has been retired, redeemed, and discharged.

In 1935, an amendment to the charter was filed and recorded merely increasing the authorized number of shares of preferred stock from 400 to 1400, but retaining the same restriction as to dividends. At the stock-

holders' meeting, held in 1935, the following resolution was adopted:

> RESOLVED, That the preferred stock be issued at par to any creditor willing to accept same in full payment of his claim. (R. 67).

Thereupon the outstanding preferred stock issue was increased from 400 to 1294 shares. All of the certificates of stock, whether issued before or after the amendment to the charter, contained the following stipulation:

> FOR RIGHTS AND VOTING POWERS OF PREFERRED STOCK, SEE ARTICLE V OF CHARTER (R. 67).

In 1937, the tax year in question, there was outstanding and due by the corporation, having been issued in 1933 and 1935,—even before the law was enacted,—the amount of 1294 shares of preferred stock of the par value of $50.00 per share, a total of $64700.00, (R. 46; 67). This preferred stock was not redeemed and cancelled until May 13, 1939. No dividend of distribution was made to the common stockholders until after the complete payment and retirement of the preferred stock issue. (R. 61).

There is no dispute as to the facts. Petitioner does not disavow transferee liability. There is no denial concerning the issue of this stock, either as to amount, time issued or conditions when sold to the holders. Neither is there any question that it was issued and outstanding prior to May 1, 1936, nor that it expressly deals with the payment of dividends. The Commissioner first raised the point in his 90 day letter that the preferred stock certifi-

cates "do not constitute a written contract within the meaning of Sec. 26 (c) (1) of the Revenue Act of 1936." (R. 17). The Record shows, without contradiction, that the original holders of the preferred stock were not the same as the holders of common stock. (R. 43-44).

The preferred stock was issued by the corporation and accepted by various creditors and investors in good faith and with special reliance upon the provision against any dividends until their debt or investment had been paid in full. This agreement was complied with punctually by the corporation and no dividend was paid until the preferred stock was paid off and retired in 1939. The Commissioner conceded in his brief in the 5th Circuit Court (Page 13) that under ordinary principles of contract law the certificates in question *did* represent an enforceable agreement between the corporation and its preferred stockholders, but argued that it was not the kind of agreement to which the statute has reference.

The Decision Below.

The Fifth Circuit held that the stock certificates were not contracts under said Sec. 26 (c) (1). (R. 81-86). It based its decision upon *"Helvering v. Northwest Steel Mills," 311 U. S. 46.* It said that while the precise question in the *Northwest Steel Mills* case was whether the provisions of a state statute could be read into a corporate charter so as to form a contract containing the restricting provisions required by Sec. 26 (c) (1), much of what was said is applicable to the facts of this case. It said that it found "most persuasive" the holding (in the *Northwest Steel Mills* case) that the credit was intended to apply only

to corporations contractually oligated to set earnings aside for the *payment of debts.* Circuit Judge Hutcheson disagreed and wrote a dissenting opinion criticizing the conclusion of the majority that the taxpayer is not entitled to the credit it claimed. He stated that the majority opinion was "bottomed on a dictum contained in an opinion of the Supreme Court which decided an entirely different question arising on an entirely different set of facts from that presented here". He expressed the view that his Court,(1) as well as this Court,(2) has considered it settled that when a statute is plainly and clearly written it must be applied as written, even where such construction advantaged the taxpayer.

Specification of Errors.

1. The Fifth Circuit Court erred in holding that the provisions prohibiting dividends in the charter and stock certificates of transferror corporation do not constitute a written contract executed by the corporation. The stock certificates were written and signed by the corporate officers, delivered to and accepted by the preferred stockholders, thus evidencing an explicit understanding which constituted a written contract executed by the corporation within the meaning of the statute.

2. The Fifth Circuit Court erred in holding that the case of *Helvering v. Northwest Steel Rolling Mills, 311 U. S. 46,* was decisive of the present controversy. This Court held in that case that a state statute prohibiting a deficit corporation from paying dividends was not a written contract executed by the corporation. What prevents

(1) Sabine Tr. Co. v. Commissioner, 128 F. (2) 945; 87 L. Ed. 373.
(2) Helvering vs. Credit Alliance Corporation, 316 U. S. 107.

the payment of dividends here is an express and binding contract evidenced by the stock certificates completely and entirely forbidding the payment of dividends.

3. The Fifth Circuit Court erred in holding that Sec. 26 (c) (1) of the 1936 Revenue law requires that the credit against surtax upon undistributed profits only applies to corporations contractually obligated to set earnings aside for the payment of debts. It is sub-section (2), not sub-section (1), of this same section of the 1936 Act which pertains to contracts dealing with the disposition of earnings and profits in discharge of debts.

Summary of Argument.

Hercules Gasoline Company, Inc. (Louisiana) had issued prior to May 1, 1936, preferred stock certificates containing an express prohibition against the payment of any dividends until all of the preferred stock was paid and discharged in full. During the entire tax year, 1937, these outstanding certificates amounted to a total of 1294 shares of the par value of $50.00 per share, a total of $64,700.00.

Congress, in 1936, levied a surtax on undistributed profits of corporations but particularly provided that *credits shall be allowed* to corporations which have placed it beyond their power to declare dividends. Cf. Appendix 29. The law required a written contract expressly dealing with the payment of dividends executed prior to May 1, 1936. The only objection raised by the Commissioner to

the preferred stock issue of transferror corporation is that the preferred stock issue of the corporation "does not constitute a written contract". There is no dispute that the issued stock certificates expressly deal with the payment of dividends or that they were executed prior to May 1, 1936. Thus the sole issue here is whether the certificates constituted a "contract".

Petitioner maintains that the corporation was bound by a valid contract with its preferred stockholders to pay no dividend until all of the preferred stock was recalled and discharged in full. Petitioner maintains that Congress did not define or distinguish the contracts which it had in mind and that the language used in the law is plain and unambiguous. The enforcement of the undistributed profits tax by the Commissioner in the present case levied under Section 14 of the 1936 Act disregards Sec. 26 of the same law and petitioner argues that such construction distorts the law and would force corporations to violate their valid written agreements in order to avoid the tax imposed.

Petitioner maintains further that the Fifth Circuit Court in the decision under review put its decision on erroneous grounds when it stated that the decision in *Northwest Steel Rolling Mills* case applied to the facts present here. This case involves certificates of stock containing an explicit understanding which was reduced to writing, signed by the President and Secretary of the corporation, whereas the *Northwest Steel Rolling Mills* case involved no such contract but only a statute prohibiting

deficit corporations from paying dividends. Petitioner maintains that when the Fifth Circuit Court said that it found "most persuasive" the holding in the *Northwest Steel Rolling Mills* case that the credit was intended to apply only to corporations contractually obligated to set earnings aside for the payment of debts, it thereby disclosed its lack of apprehension of this Court's decision in the cited case. By this line of reasoning, the Court showed that it was deciding the issue under Section 26 (c) (2) of the Revenue Act of 1936, which limits any contract to one concerning the discharge of debts, instead of under Sec. 26 (c) (1) which applied to an outright prohibition against dividends by a written contract with anyone.

ARGUMENT.

I.

The Fifth Circuit Court erred in holding that the provisions prohibiting dividends in the charter and stock certificates of transferror corporation do not constitute a written contract executed by the corporation. The stock certificates were written and signed by the corporate officers, delivered to and accepted by the preferred stockholders, thus evidencing an explicit understanding which constituted a written contract executed by the corporation within the meaning of the statute.

That the respective rights and obligations of the corporation and the stockholders as set forth in a certificate of stock becomes a contract between the corporation and the stockholders seems to be held with such unanimity

by the courts of the land that it seems strange that the contrary should be seriously argued.

See:

Words & Phrases (Perm. Ed.) "Contract" Vol. 9, p. 226-267, 1945 Supp. p. 56;
Warren v. King, 108 U.S. 389, 27 L. Ed. 769;
Geiger v. American Seeding Machine Co., 124 Ohio St. 222, 177 N.E. 594, 79 A.L.R. 614;
11 Fletcher Cyclopedia, Corps., Perm. Ed., Sec. 5295, page 730.
Chase v. Hibernia Nat. Bank, 44 La. Ann. 69, 10 So. 379;
13 Am. Jur. 224, 398;
Gallagher v. New York Dock Co., 19 N. Y. S. (2nd) 789;
Lee v. Fisk, 109 N.E. 833.
U. S. Radiator Corp. v. State of N. Y., 101 N.E. 783, 46LRA (NS) 588;
Annotation: 154 ALR 418;
Strout v. Cross, A&I Lbr. Co., 28 NE (2d) 890, 133 ALR 646;
Annotation: 133 ALR 653.

It is well established in our jurisprudence that obligations not set forth at length in a written contract may be incorporated by specific reference or even by implication.(1)

The Louisiana Corporation Law, Act 250 of 1928, is a State enactment of the Uniform Business Corporation

(1) Helvering vs. Northwest Steel Rolling Mills, 311 U. S. 49.

Law. Section 14 of this statute, as amended, sets forth the form and content of certificates of stock; sub-section II of Sec. 14 provides that "Every certificate of stock shall state

. . . . . .

(e) "If the corporation is authorized to issue shares of more than one class, the rights, voting powers, preferences and restrictions granted to or imposed upon the shares of each class, or *a reference to the articles relating thereto.*" See Appendix, p. 31.

It is common practice in Louisiana to refer to the Articles and thus save extensive printing on the face of stock certificates. Hercules Gasoline Company, Inc., observed this practice and followed this law by referring on the stock certificates, both common and preferred, to Article V of the charter.

Louisiana has the Uniform Stock Transfer Act—Act 180 of 1910—under which the title to corporate shares passes by delivery of the certificate of stock. Thus, it was not necessary for the preferred stockholders to sign anything in order to bind the corporation, any more than for the purchaser in a cash deed, or the buyer of a note or a bond issue to subscribe. These stock certificates were written and they were "executed by the corporation." Furthermore, they were paid for and accepted by the holders and owners as obligations of the corporation.

The original bill in Congress, after discussion and amendment in Committee, finally came out of the legisla-

tive mill with the word "contract" and thereupon the law of the land said "contract". This is a generic word, comprehending every species and character of agreement.

Under our constitutional organization, the governmental powers are distributed among three departments, legislative, executive and judicial. Courts have no legislative authority and they should avoid judicial legislation or an entry into the legislative field.(1) It is not within the province of a court, in the course of construction of a statute, to make or supervise legislation. A statute may not, under the guise of interpretation, be modified, distorted or rewritten, or given a construction of which its words are not susceptible. To depart from the meaning expressed by the words of a statute is to alter it and is not construction, but legislation.

The *Louisiana Civil Code, Article 1761*, defines a contract as follows:

> "A contract is an agreement by which one person obligates himself to another, to give, to do or permit, or not to do something, expressed or implied by such agreement."

A contract is defined in *12 Am. Jur., page 496*, as follows: "An agreement by which a person undertakes to do or not to do a particular thing." *Cf. Louisiana Act 250 of 1928, Section 1 and Section 14.* See *Restatement of the Law, Contracts, p. 1.*

A controversy very similar in nature to the present case, where conclusions were reached contrary to the deci-

(1) Iselin vs. U. S., 270 U. S. 245, 250, 251; 70 L. Ed. 569.

sion under review, is that of *Lehigh Structural Steel Company v. Commissioner, 127 F. (2nd) 67*, decided by the Third Circuit Court in 1942.

The Court said:

"Where amendment of Delaware corporation charter, accepted by stockholders and filed with Secretary of State of Delaware provided for sinking fund for retirement of preferred stock by setting aside percentage of net earnings after payment of preferred dividends and before paying other dividends, and such provision was set out in preferred stock certificates, corporation in determining undistributed profits surtax was entitled to credit for so much of profits, as corporation paid into sinking fund on ground that each certificate constituted a 'contract' within statute authorizing credit for surtax purposes for profits which corporation could not distribute as dividends without violating written contract executed by corporation." Revenue Act 1936, No. 14, 26 (c) (1) 26 U.S.C.A., Int. Rev. Acts, pages 823, 836.

"We are clear that nothing ruled in the Northwest Steel Rolling Mills Case is dispositive of the present situation. In the present case the parties reached an explicit understanding, as is evidenced by the amendments to the certificate of incorporation proposed by the petitioner's Board of Directors, accepted by the stockholders and filed with the Secretary of State of Delaware. The agreement was thereafter set forth in detail in the

stock certificates, each of which was executed by the corporation and each of which dealt expressly with the payment of dividends. Finally these writings were delivered by the corporation to the parties with whom it was contracting, namely, the owners of its stock. We conclude that the stock certificates which were issued by the petitioner prior to May 1, 1936, meet the statutory test. The petitioner was, therefore, entitled to the credits claimed."

See also:

Budd v. Commissioner, 143 F. (2) 784;

Philadelphia Record Company v. Commissioner, 145 F. (2) 613;

Eljer Company v. Commissioner, 134 F. (2) 251.

The case of *Rex-Hanover Mills Company v. U. S. 53 F. Supp. 235* is a controversy involving similar facts and the same legal issue as involved herein and was decided by the Court of Claims in 1944.

The Court said:

Agreement of corporation printed on preferred stock certificates issued in 1933 requiring corporation to provide a sinking fund before payment of dividends on any class of stock other than preferred stock constituted a "written contract executed by corporation" restricting payment of dividends within statute authorizing credit for surtax purposes for profits which corporation can-

not distribute as dividends without violating such a contract. Revenue Act 1936, Secs. 14, 26 (c) (1) 26 U.S.C.A. Int. Rev. Acts, pages 823, 836.

The facts in the present case establish a contract relationship between the corporation and its preferred stockholders. The owners of this stock accepted the preferred stock issued to them under the guarantees supporting the sale of the stock and with the full intention of getting back their interest and principal before there should be any distribution of earnings by the corporation to the common stockholders. There was a meeting of minds on this point.

In the case of *Montpelier Academy Trustees v. George, 14 La. 395*, the Supreme Court of Louisiana, over 100 years ago, stated that incorporators acquired vested rights in the nature of a contract which cannot be taken from them by the State without a manifest violation of the Constitution of the United States. The Supreme Court of Louisiana, in the case of *Boykin and Lang v. Shaffer, 13 La. Ann. 129*, followed the *Montpelier* decision and held an act of the Legislature unconstitutional as impairing the obligation of a contract.

See also:

African M.E. Church v. New Orleans, 15 La. Ann. 441;

Louisiana Board of Trustees v. Dupuy, 37 La. Ann. 188;

Carondelet Canal & N. Co. v. Lugger, et al., 37 La. Ann. 100;

Boisdere v. Citizens Bank, 9 La. 506;
Hunter v. Chicago Lbr. & Coal Co., 156 La. 19, 100 So. 35.
Cf. Sutton v. Globe Knitting Works, 276 Mich. 200; Note 105 ALR 1452; 117 ALR 1290.

Treigle v. Acme Homestead Assn., 297 U. S. 189, 80 L. Ed. 575, held as follows:

> "Contracts between members of building and loan associations and the associations can not be abrogated, for no discernible public purposes, under the guise of amending the charter powers of the corporation." (Reversing 181 La. 941).

The primary purpose of this surtax upon undistributed profits was to stimulate the distribution of corporate dividends so that the tax could be collected from individual shareholders.(1) It is a fundamental principle of statutory construction that the intention of the legislature is the most important guide and that it will be presumed that unfair and undue hardships are not intended. The Commissioner in the administration of this law, instead of giving the law a literal construction, attempts to say that Congress only intended to give credit against the tax *under certain types of contract*, and that a preferred stockholder-corporation is not the type he thinks Congress meant. Congress must be presumed to give these words their plain and ordinary meaning. A "written contract" embraces all kinds of written agreements made by the corporation.

(1) Reed Drug Co. vs. Commissioner, 130 F. (2nd) 288.

This Court has *(Hawaii v. Mankichi, 190 U. S. 214, 47 L. Ed. 1021)* stated that nothing is better settled than that statutes should receive a sensible construction, such as will effectuate the legislative intention, and, if possible so as to avoid an unjust or an absurd conclusion.

See:

Barret v. Van Pelt, 268 U. S. 85-90, 69 L. Ed. 857;

Fleischman Con. Co. v. U. S., 270 U. S. 349, 70 L. Ed. 624.

Eminent authorities on the subject of Federal Taxation have pointed out the distinguishing features of 26 (c) (1) and 26 (c) (2) of the statute, stating that one relates to prohibitions on distribution and presumably including preferred stock and other contracts, the other sub-section referring to amounts used to pay corporate debts.(1)

The Internal Revenue Bureau of the Government in 1937 and 1938 gave credit for these contracts with much more liberality.(2) This attitude of interpretation even went so far as to allow credit under Sec. 26 (c) (1) by virtue of provisions in preferred stock certificates.(3)

The Second Circuit Court, in *Monarch Theatres, Inc., v. Commissioner, 137 F. (2nd) 588* considered a legend

(1) Paul and Mertens, Law of Fed. Income Taxation, 1939 Cumulative Supp., Secs. 32A39, 32A40, 32A43 and 32A45B;

(2) I. T. 3130, Int. Rev. Bulletin, Cumulative Bulletin, 1937-2 (July-December 1937) page 107-9;

(3) I. T. 3139, Int. Rev. Bulletin, Cumulative Bulletin, 1937-2 (July-December 1937) page 111; I. T. 3152 Int. Rev. Bulletin, Cumulative Bulletin 1938-1 (January-June, 1938) page 155.

on stock certificates concerning dividends and concluded that even though the Court should agree that a shareholder's certificate was a contract executed by the corporation, it would not serve as a prohibition because it was not a promise not to pay dividends. The Court granted credit to the corporation, however, under a corporate resolution, stating that a resolution of the directors of the corporation amounted to a contract because it was reduced to writing and executed by the Board of Directors and was binding on the corporation in respect to the provision limiting the power to declare dividends.

Along the same line, the Sixth Circuit Court recently held, in *Automotive Parts Company v. Commissioner, 134 F. (2nd) 420* that a telegram from a creditor, a letter from the corporation agreeing to limit dividends and an approving letter from the creditor, when considered as a whole agreement, constituted a written contract executed by the corporation under this law.

Other cases not concerning stock certificates but involving the question of what constitutes a restrictive contract, are *Harding Glass Company v. Commissioner, 142 F. (2nd) 41* and *U. S. v. Hillcrest Inv. Co., 147 F. (2nd) 194.*

We confidently believe that Congress did not intend to tax a corporation for not distributing its profits if the corporation had made a binding agreement not to distribute its profits. The best evidence that this was the law maker's intention is found in the plain and understandable language used in the enactment. We ask that

the provision be literally construed. We cannot presume an intention to place a premium on a breach of contract or to give a credit when an illegal distribution was made. We are confident that the facts in the present case meet the statutory test and clearly establish a contract relation between the corporation and the holders of preferred stock for which credit should be given.

II.

The Fifth Circuit Court erred in holding that the case of Helvering v. Northwest Steel Rolling Mills, 311 U. S. 46 was decisive of the present controversy. This Court held in that case that a state statute prohibiting a deficit corporation from paying dividends was not a written contract executed by the corporation. What prevents the payment of dividends here is an express and binding contract evidenced by the stock certificates completely and entirely forbidding the payment of dividends.

The Fifth Circuit Court said that they thought the reasoning and pronouncements of this Court in the *Northwest Steel Rolling Mills* case applied to the facts present here. The Court admitted that the precise question in that case was whether the provisions of a state statute could be read into a corporate charter so as to form a restrictive contract, but it thought that much of what was said in that case was applicable to the present case involving stock certificates.

The Tax Court had not felt bound by the rule of this Court in the *Northwest Steel Rolling Mills* case. The

Fifth Circuit Court held that the principle of the *Northwest Steel Rolling Mills* case applied even when Government counsel in brief in the Fifth Circuit conceded that the certificates in question *did represent* an enforceable agreement between the corporation and its preferred stockholders,—which admission had eliminated the main feature of the *Steel Mills* case. There is no suggestion in the recorded opinion of the *Steel Mills* case that the stock certificates added anything to the restriction contained *in the law* of Washington.

In the opinion of this Court, delivered by Justice Black, you stated the crux of the matter thus:

> "We must therefore decide whether Sec. 26 (c) (1) authorized a credit or deduction to corporations prohibited by state law from distributing dividends."

Of course, with the admission by the Respondent in the 5th Circuit Court that under ordinary principles of contract law the preferred stock certificates *did* represent an enforceable, written contract, the decision of this Court denying credit to corporations prohibited by state law had no logical bearing whatsoever upon the legal issue. That case could not serve as authority for a decision involving an actual, written agreement between competent parties. By their holdings, the Fifth Circuit Court failed to follow the outright rule of the *Steel Mills* case as to Sec. 26 (c) (1) but accepted as binding the *obiter dicta* of said case under Sec. 26 (c) (2). See the criticism of

this holding by Judge Hutcheson in his dissenting opinion. (R. 84).

The Fifth Circuit Court also said that Your Honors in the *Steel Mills* case held that the prohibition against dividend payments must be expressly written in the executed contract and could not be incorporated therein by reference, implication or otherwise. We submit that there was no such holding by Your Honors in the cited case. May we refer again to the language of the Court:

> "The natural impression conveyed by the words 'written contract executed by the corporation' is that an explicit understanding has been reached, reduced to writing, signed and delivered. True, obligations not set out at length in a written contract may be incorporated by specific reference or even by implication."

The Fifth Circuit raised this technical point for the first time. The Commissioner has never disputed the validity of a written contract incorporating specific provisions by reference.

Matters contained in other writings which are referred to may be regarded as a part of the contract and may, therefore, properly be considered in the interpretation of a contract. Where a contract is executed which refers to another instrument or makes the conditions of such other instrument a part of it, the two will be interpreted together as the agreement of the parties. Two instruments executed at the same time as one transaction in order to effectuate a single purpose, and each referring

to the other, must be considered together.[1] The law of Louisiana governing the organization of business corporations (Appendix, p. 31) authorized this reference in the charter to the certificates. Mortgage contracts in Louisiana are merely brief promises to pay in note form which are identified by the Notary with the act of mortgage which procedure by reference makes all of the provisions of the recorded mortgage a part of the written note.[2] See also *Guerini Stone Co. v. Carlin, 240 U. S. 264.*

The *Steel Mills* case is not in point to the present controversy when the test of similarity of controlling facts is applied. The language and general expressions in an opinion of a Court should be taken in connection with the facts and issues involved in the particular record under investigation in which those expressions are used and must be construed in the light of the issue in controversy in the decided case. They should not be extended beyond the controlling facts for any purpose of authority in another and different case[3] under any theory of *stare decisis.*

The contention of the taxpayer (and the question for decision) in the *Northwest Steel Mills* case was that it was prohibited by *State Law* from distributing 1936 profits because of a previously existing deficit. The taxpayer attempted to draw into its charter the provisions

(1) 12 Am. Jur. 781 et seq.; Restatement of the Law, Contracts, p. 283; 128 ALR 1024.

(2) La. Revised Civil Code, Art. 3384.

(3) 14 Am. Jur. Courts, p. 283 et seq.

of the state law of Washington which stated that "no corporation should pay dividends except from the surplus of the aggregate of its assets over the aggregate of its liabilities." There was no contract executed by the corporation! There is a complete contract in the present case and a state law is not involved.

It would appear clear from the above discussion that the Fifth Circuit Court followed the decree of the *Steel Mills* case, but failed to follow the reasoning; that it adopted as controlling the portions of the opinion which were adverse to the present taxpayer, but disregarded the holdings in that opinion which were favorable to it.

This Court held in the cited case that all that is required under this Section of the 1936 law is "an explicit understanding, reduced to writing, signed and delivered." The certificates of stock of Hercules Gasoline Company, Inc., were signed by the President and Secretary; they contained by specific reference the dividend prohibition and they were delivered to and accepted by the preferred stockholders.

The decision of this Court in the *Steel Mills* case was, primarily, an interpretation of Sec. 26 (c) (1) of the 1936 Revenue Act. In concluding that the law does not authorize a credit when applied to statutorily prohibited dividends, the Court thought such construction of Sec. 26 (c) (1) was further *supported* by a consideration of Sec.

26 (c) (2). It was of Sec. 26 (c) (2) that the Court said: "That this section referred to routine contracts dealing with ordinary debts and not to statutory obligations is obvious." The Court further disposed of the claims of the taxpayer to credit as a deficit corporation by a consideration of the legislative history of Sec. 26 (c) (1). This history showed that the contract credit was never out of the bill, altho the deficit provisions were eliminated.

The 3rd Circuit in the *Lehigh* Case[1] did not feel bound by the *Steel Mills* decision, neither did the 2nd Circuit in the *Monarch Theatres* case,[2] nor did the Court of Claims in the *Rex-Hanover* decision.[3]

The authority used as a foundation for the decision under review did not decide whether stock certificates forbidding payment of dividends constituted a contract within the purview of this law and it was error for the Fifth Circuit to bottom its conclusion on the *Steel Mills* case.

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(1) The Court said:

"We are clear that nothing ruled in the Northwest Steel Rolling Mills case is dispositive of the present situation."

(2) The Court said:

"The often quoted language of Mr. Justice Black in the Northwest Steel Rolling Mills, supra, 311 U. S. 46. . . was used discursively and by way of example; it is not to be understood as laying down absolute doctrine."

(3) The same idea was put thus:

"We think the Supreme Court could hardly have intended to read into Sec. 26 (c) (1) a limitation of the written agreements there mentioned to agreements with creditors, when the Court's language was directed to Sec. (c) (2) which expressly deals only with written agreements requiring that earnings be set aside for the 'discharge of a debt.'" (53 Fed. Supp. 246).

III.

The Fifth Circuit Court erred in holding that Section 26 (c) (1) of the 1936 Revenue Law requires that the credit against surtax upon undistributed profits only applies to corporations contractually obligated to set earnings aside for the payment of debts. It is sub-section (2), not sub-section (1), of this same section of the 1936 Act which pertains to contracts dealing with the disposition of earnings and profits in discharge of debts.

This portion of our argument has been covered in discussing the other points. See Brief, above.[1]

Section 26 (c) (1) (See Appendix), *does not provide* that one who holds a contract restricting the payment of dividends or the one with whom a corporation is dealing, must be a creditor of the corporation; neither does it exclude the provisions commonly found in certificates of preferred stock. The contract credit leaves the door wide open for stockholder-corporation contracts! The emphasis in Sec. 26 (c) (1) is upon the word "violating". If the contract will be violated by the payment of a dividend, then there is a contract credit, exactly the same as the credit which results from dividends paid. No actual payment or setting aside is required, a mere prohibition being sufficient. If there are two or more such contracts, then the largest will result in a credit.

(1) Paul and Mertens Law of Fed. Income Taxation, 1939 Cumulative Supplement, Sec. 32A39.

Thus, under the first sub-section there may be a prohibition concerning either a debt or an investment. If an issue of preferred stock must be retired before dividends are paid, such an investment contract would clearly come under the provisions of Sec. 26 (c) (1) and would qualify for the credit.

Section 26 (c) (2) is entirely different. It allows a credit where an amount equal to a portion or percentage of the profits must be paid or set aside within the year in discharge of a debt, and only to the extent that such amount has been so paid or set aside. Again, the contract must be in written form, executed before May 1, 1936, and expressly deal with the payment of dividends. As distinguished from Sec. 26 (c) (1) however, only a debt qualifies; the contract necessarily must be with a creditor of the corporation.

When the 5th Circuit Court said that the credit under Sec. 26 (c) (1) was intended to apply only to corporations contractually obligated to set earnings aside for the *payment of debts*, and stated that it found this element of the case "most persuasive", it thereby reveals reversible error because a mere glance at the Congressional enactment makes the Court's illogical thinking so plain that "He who runs may read".

Conclusion.

For the foregoing reasons, it is respectfully submitted that the judgment of the Circuit Court of Appeals for the Fifth Circuit should be reversed and petitioner be decreed entitled to the credit which it claimed.

Respectfully submitted,

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Hercules Gasoline Company, Inc.

Joseph H. Jackson,
Of Counsel for Petitioner.

APPENDIX.

Sec. 26 of the Revenue Act of 1936, 49 Stat. 1648, 1664 (26 U.S.C.A. Int. Rev. Acts, page 855-6):

Sec. 26. Credits of Corporations:

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * * * * *

(c) Contracts Restricting Payment of Dividends.

(1) Prohibition on payment of dividends. An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed,, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

((2) Disposition of profits of taxable year. An amount equal to the portion of the earnings and

profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purpose of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) Double credit not allowed. If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

* * * * * * * * *

Sec. 14 of Act 250 of La. Legislature for the year 1928, as amended:

Certificate of stock—Form of certificate.—

I. Every shareholder shall be entitled to a certificate of stock signed by the president and secretary, or by such other officers of the corporation as the articles or by-laws may provide; . . . . .

II. Every certificate of stock shall state:

(a) the state of incorporation;

(b) the name of the registered holder of the shares represented thereby;

(c) the number and class of shares represented thereby;

(d) the par value of each share represented, or a statement that such shares have no par value;

(e) if the corporation is authorized to issue shares of more than one class, the rights, voting powers, preferences and restrictions granted to or imposed upon the shares of each class, or a reference to the articles relating thereto.

III. A certificate for shares having no par value shall not state any par value, nor any value thereof in money, except in liquidation or redemption, nor any rate of dividend to which such shares shall be entitled in terms of a percentage of any par or other value. (Acts 1928, No. 250, Sec. 14; 1932, No. 65, Sec. 1).

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HERCULES GASOLINE COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR PETITIONER ON MERITS

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JOSEPH H. JACKSON,
Of Counsel for Petitioner.

December 5, 1945.

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I

The Steel Mills and Crane-Johnson Decisions Have Been Overruled by Congress

It is submitted, in reply to Respondent's brief (p. 18), that the Government cannot draw any aid or comfort from the decisions in *Helvering* v. *Northwest Steel Rolling Mills*, 311 U. S. 46, and *Crane-Johnson Co.* v. *Helvering*, 311 U. S. 54 (as well as the Circuit Court holdings which followed them), because by Sec. 501 of the Revenue Act of 1942[1]

[1] 26 U. S. C. A. Int. Rev. Acts, 1944 Supp., page 257; 56 Stat. 798; *U. S.* v. *Byron Rush & Door Co.*, 150 F. (2d) 44.

Congress reaffirmed its purpose and intention and, in effect, overruled these cases by giving retroactive credit to deficit corporations.[2] Counsel is informed that pursuant to this enactment, the Government has refunded the amounts of the judgments in these cases with 6% interest thereon.

It is settled that subsequent legislation may be considered to assist in the interpretation of prior legislation upon the same subject,[3] and it is hard to see why Congress would not want to tax corporations forbidden by law to declare dividends and want to tax those forbidden by contract to do so. The theory of the undistributed profits tax was that corporations able to declare dividends should have an option to do so and avoid the tax, but that corporations having no option were not to be taxed.

When the cases cited by the Respondent are analyzed, it will be found that they are insubstantially based. Take, for instance, the *Elliott Addressing Machine Co.* v. *Commissioner* (131 F. (2d) 700). It will be discovered that there was no stipulation prohibiting dividends. It is like the *Monarch* case (137 F. (2d) 588) in that there was no promise not to pay dividends. Therefore, neither this 1st nor 2nd Circuit Court case is pertinent to the present question.

The deficit cases cited from the 6th Circuit (*Warren, Metal Specialty, Bishop & Babcock*) are bottomed upon the *Steel Mills* case which, as we have pointed out above, has been retroactively overruled by the legislature.

On pages 11, 12 and 13 of the Respondent's brief the statement is made, followed by labored argument, that the basis of the tax was that portion of the undistributed net income

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[2] See Vol. 1, p. 1022, Hearings Before the Committee on Finance, United States Senate, on Rev. Act of 1942; Senate Finance Committee Report (No. 1631), p. 245 thereof.

[3] *Great Northern Ry. Co.* v. *U. S.*, 315 U. S. 262, 267.

of the corporation which was in excess of specified percentages of the adjusted net income. We surmise from the argument on this point that Respondent now wants to limit the credit to the sum of $64,700 due by the corporation to its preferred stockholders. Although this section is not too clear, we think Sec. 26 (c) (1) gives the basis of credit, not the basis of tax. When a contract prohibits the payment of any dividend whatsoever, as in the present case, credit "shall" be allowed against all undistributed net income.

Our reading of Sec. 26 (c) (1) and (2) is that both subsections require a "written contract executed by the corporation," but that sub-section (1) applies to prohibitions against distributions and sub-section (2) applies to requirements as to dispositions in discharge of debts. Naturally, either contract would make the corporation unable to distribute surplus profits.

II

We Rely upon the Stock Certificates, Not the Charter, for the Contract

Respondent argues also that transferor's charter was not "executed" by the corporation and that the stock certificates did not "expressly" prohibit the payment of dividends (Br., p. 33, et seq.). As to these strained arguments, now made for the first time, we believe we have answered these points in our original brief. Of course, we are not relying upon a charter as a contract executed by the corporation and would make note that the charter in the *Steel Mills* case did not contain any restriction. We do rely upon the written, executed stock certificates as a contract executed by the corporation which carried by specific reference the dividend restriction. In Louisiana, where this contract was made, the highest court has held that the maxim of the law in interpreting contracts is that words referred to

are considered as incorporated in the instrument.[4] In support of these points in the brief, respondent cites no binding authority or governing principle.

Under our civil law, agreements legally entered into have the effect of laws on those who have formed them. They cannot be revoked unless by mutual consent of the parties or for causes acknowledged by law. They must be performed with good faith (La. Revised Civil Code, 1901; 1945-6).

When this particular case is stripped of its legalistic clothing down to its bare issue, it is plain that the Commissioner is attempting to force the officers of the corporation, against their will, to violate their contract not to pay dividends or suffer a heavy penalty for not doing so. His forcible intrusion manifestly impairs the rights of property and invades the rights and powers of management of the corporation by its officers and stockholders. What respondent wants is not construction, but enlargement.

III

Doesn't the Respondent Want This Court to Supply Omissions, or to Enlarge, the Statute?

Respondent suggests that Congress did not intend to include this *kind* of contract in the credit provisions. Congress did not define or limit the written contract. The Commissioner by his ipse dixit ruled that the stock certificates do not constitute a written contract executed by the corporation within the meaning of this law. What reason does he have for separating contracts into different *kinds?* What proof has he that Congress was not intending to include all contracts? On what ground can he create this exception or demand this exclusion? What principle or reason supports

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[4] *Weinberger* v. *Insurance Company*, 41 La. Annual 31.

the distinction? Are these contracts concerning the sale of corporate stocks and securities of so little estimation in the United States that they must be excluded from the protection of words which, in their natural import, include them? Are the ordinary rules of construction to be disregarded in order to leave such agreements exposed to alteration or to overriding by the Commissioner? Is his summary ruling binding on the taxpayer? He has no judicial functions!

This corporation was bound by a bona fide contract, containing all elements of mutuality and validity, not to declare dividends. This contract was entered into in 1933. It was confirmed by amendment to the charter in 1935. It was fully performed in 1939. It was only in 1942 that the Commissioner construed the agreement as not constituting a written contract.

In conclusion, and referring again to the reaction of Congress to the cases involving deficit corporations, may we reemphasize the proposition:

Why should Congress not want to tax corporations forbidden by law to declare dividends and to tax those forbidden by contract to do so?

Respectfully submitted,

MELVIN F. JOHNSON,
Counselor for Petitioner.

December 5, 1945.

No. 93

In the Supreme Court of the United States

OCTOBER TERM, 1945

HERCULES GASOLINE COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court of the United States (R. 98–102) is unreported; the opinion of the Circuit Court of Appeals (R. 114–117) is reported at 147 F. 2d 972.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 1, 1945 (R. 119). The petition for rehearing was denied on April 19, 1945 (R. 123). The petition for a writ of certiorari was filed on May 28, 1945. The jurisdic-

tion of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether petitioner's transferor corporation was entitled, under Section 26 (c) (1) of the Revenue Act of 1936, to a credit against undistributed profits tax for 1937, where the claim for credit rested upon a provision of the transferor's stock certificates.

STATUTES INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648, 1664:

> SEC. 26. CREDITS OF CORPORATIONS.
>
> In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—
>
> * * * * *
>
> (c) *Contracts Restricting Payment of Dividends.*—
>
> (1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. * * *
>
> * * * * *

STATEMENT

The pertinent facts, taken from the findings of the Tax Court (R. 92–98), are as follows:

The petitioner is a Delaware corporation organized in 1939 and domiciled in Wilmington. It admits liability as transferee of the assets of Hercules Gasoline Company, Inc. (hereinafter called the transferor), a Louisiana corporation, which was dissolved in 1939. (R. 92–93.)

The original charter of the transferor duly filed and recorded in the state of its domicile in 1933 contained the following (R. 93–94):

> ARTICLE V
>
> The capital stock of this corporation is hereby fixed at 3,000 shares of no par value common stock and 400 shares of $50.00 par value of preferred stock, which said stock shall be paid for in cash at the time of issuance or for service rendered or property actually received and shall be full-paid and nonassessable.
>
> The following rights, privileges and conditions shall attach to the shares aforesaid, viz:
>
> (a) The preferred stock shall be entitled, out of any and all surplus net profits whenever declared by the Board of Directors, to cumulative dividends at the rate of 8% per annum for each and every year from the issuance of such stock, payable semi-annually, in preference and priority to any

payment of any dividend on the common stock for such year.

* * * * * *

(c) The common stock shall be subject to the prior rights of the holders of the preferred stock as above declared and there shall be no dividend on the common stock until all of the preferred stock has been retired, redeemed and discharged.

* * * * * *

At a meeting of the stockholders of the transferor held in 1935, a resolution was adopted to amend the charter in order to increase the authorized number of shares of preferred stock from 400 to 1,400, which amendment was duly filed and recorded. The amendment as contained in the resolution and as made to the charter was in the same language as that contained in Article V of the original charter except that the number of shares of preferred stock was shown as 1,400 instead of 400. (R. 94–95.)

All certificates of preferred stock, whether issued before or after the amendment to the charter, contained the following provision (R. 95):

> For Rights and Voting Powers of Preferred Stock See Article V of Charter.

During 1937 and 1938 the transferor had outstanding 1,294 shares of preferred stock of a total par value of $64,700, all of which had been issued prior to May 1, 1936, and all of which were retired in 1939 (R. 95).

In assessing the deficiency for 1937, the Commissioner determined that the provision in the transferor's charter which prohibited the payment of dividends on common stock so long as any of the preferred stock was outstanding, did not constitute a contract prohibiting the payment of dividends within the meaning of Section 26 (c) (1) of the Revenue Act of 1936 (R. 96–97). The Commissioner was sustained in the Tax Court, and the Circuit Court of Appeals, with one judge dissenting (R. 117–119), affirmed (R. 114–117).

ARGUMENT

This case does not warrant further review because it was correctly decided in accordance with principles enunciated by this Court in *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, and the statutory provision involved has been superseded. While we concede that the Court of Claims [1] and the Circuit Court of Appeals for the Third Circuit [2] do not share the view of the majority below and of the other Circuit Courts of Appeals [3] that

[1] *Rex-Hanover Mills Co.* v. *United States*, 53 F. Supp. 235.

[2] *Lehigh Structural S. Co.* v. *Commissioner*, 127 F. 2d 67; cf. *Monarch Theatres* v. *Helvering*, 137 F. 2d 588 (C. C. A. 2d).

[3] *Warren Tel. Co.* v. *Commissioner*, 128 F. 2d 503 (C. C. A. 6th), certiorari denied, 317 U. S. 697; *Elliott Addressing Machine Co.* v. *Commissioner*, 131 F. 2d 700 (C. C. A. 1st). See also *Commissioner* v. *E. G. Atkins & Co.*, 127 F. 2d 783 (C. C. A. 7th); *Atlas Supply Co.* v. *Commissioner*, 123 F. 2d 356 (C. C. A. 10th); *Mastin Realty & Min. Co.* v. *Commissioner*, 130 F. 2d 1003 (C. C. A. 8th).

the *Northwest Steel* decision requires the denial of credit where, as here, the dividend restriction relied on is embodied in a contract within the corporate framework rather than outside it, we believe that at this date there is small reason for this Court to resolve the divergency of opinion. Later revenue laws contain no provision corresponding to Section 26 (c) (1) of the 1936 Act, *supra*, p. 2, and the number of cases still concerned with that Section is consequently unappreciable. Furthermore, before questioning the applicability of the *Northwest Steel* decision, the petitioner must hurdle the fact that the provision relied upon does not actually prohibit the payment of dividends but is merely an intracorporate agreement as to priorities in their payment. See the opinion on rehearing in *Budd International Corp.* v. *Commissioner*, 143 F. 2d 784, 793 (C. C. A. 3d), certiorari denied, 323 U. S. 802.

The courts which hold that under the *Northwest Steel* decision credit is not allowable where corporate charter or stock certificates contain the critical provision[4] ground their opinion principally on this Court's statement in that case that the kinds of agreement which Congress had in mind in Section 26 (c) (1) were "routine contracts dealing with ordinary debts" (311 U. S. at p. 50). Manifestly, a promise by a corporation to some of its shareholders that it

[4] See fn. 3, *supra*, p. 5.

will not pay dividends to other shareholders except under specified conditions is not a routine contract dealing with ordinary debts. As the majority opinion below states (R. 117)—

> The shareholders of a corporation are not its creditors; they are its owners.

It was to corporations which were contractually obligated to set aside earnings for the protection of creditors that Congress intended to afford the grace of Section 26 (c) (1).*

It is true that the precise question in the *Northwest Steel* case was whether a state statute prohibiting dividend payments under certain conditions was a "contract" provision within the meaning of Section 26 (c) (1). But the argument there ran in part that the state statute was an implied-in-law term of the corporation's charter, and therefore the taxpayer necessarily was urging

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* See the following remarks of Representative Samuel B. Hill, Chairman of the Subcommittee on Taxation of the Commitee on Ways and Means (80 Cong. Record 6004):

> * * * I am now going to call attention to section 15, which deals with contracts not to pay dividends. If a corporation as of March 3, 1936, finds itself in a position, *by reason of a contract entered into with its creditors*, not to pay dividends until it has paid its creditor his debt or has established a sinking fund, or otherwise provided means of paying the obligation, if it is under that handicap by reason of a written contract, then we allow the corporation a 22½-percent flat rate on that portion of the net income which it is unable to pay out, by reason of this contract, in dividends. [Italics supplied.]

that the charter itself was a "contract" within the intendment of the federal statute. Hence we think that this Court's statement that the kind of agreement to which Congress had reference was a routine contract dealing with ordinary debts was more than mere dictum (cf. Pet. 11). Moreover, this Court further stated in the *Northwest Steel* case that, conceding a corporate charter to be a "contract" for some purposes—

> it does not follow that Congress intended to include corporate charters and related state laws in the cautiously limited area permissible for tax credits and deductions under this section (311 U. S. at p. 51).

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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JULY 1945.

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OPINIONS BELOW

The memorandum opinion of the Tax Court of the United States (R. 69–72) is unreported; the majority and dissenting opinions of the Circuit Court of Appeals (R. 81–86) are reported at 147 F. 2d 972.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 1, 1945 (R. 86). The petition for rehearing was denied on April 19, 1945 (R. 89). The petition for a writ of certiorari was filed on May 28, 1945, and granted on October 8, 1945 (R. 91). The jurisdiction of

this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether credit against undistributed profits tax is allowable under Section 26 (c) (1) of the Revenue Act of 1936 where the claim rests upon a provision of the taxpayer's stock certificates incorporating by reference a term of its charter.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations will be found in the Appendix, *infra*, pp. 37–42.

STATEMENT

The pertinent facts, taken from the findings of the Tax Court (R. 64–69), are as follows:

The petitioner is a Delaware corporation organized in 1939 and domiciled in Wilmington. It admits liability as transferee of the assets of Hercules Gasoline Company, Inc. (hereinafter called the transferor), a Louisiana corporation, which was dissolved in 1939. (R. 65.)

The original charter of the transferor duly filed and recorded in the state of its domicile in 1933 contained the following provision (R. 65–66):

> ARTICLE V
>
> The Capital stock of this corporation is hereby fixed at 8,000 shares of no par value common stock and 400 shares of $50.00 par

value of preferred stock, which said stock shall be paid for in cash at the time of issuance or for service rendered or property actually received and shall be full-paid and nonassessable.

The following rights, privileges and conditions shall attach to the shares aforesaid, viz:

(a) The preferred stock shall be entitled, out of any and all surplus net profits whenever declared by the Board of Directors, to cumulative dividends at the rate of 8% per annum for each and every year from the issuance of such stock, payable semi-annually, in preference and priority to any payment of any dividend on the common stock for such year.

* * * * *

(c) The common stock shall be subject to the prior rights of the holders of the preferred stock as above declared and there shall be no dividend on the common stock until all of the preferred stock has been retired, redeemed and discharged.

* * * * *

At a meeting of the stockholders of the transferor held in 1935, a resolution was adopted to amend the charter in order to increase the authorized number of shares of preferred stock from 400 to 1,400, which amendment was duly filed and recorded. The amendment as contained in the resolution and as made to the charter was in the same language as that contained in Article

V of the original charter except that the number of shares of preferred stock was shown as 1,400 instead of 400. (R. 66–67.)

All certificates of preferred stock, whether issued before or after the amendment to the charter, contained the following provision (R. 67):

> For Rights and Voting Powers of Preferred Stock See Article V of Charter.

During 1937 and 1938 the transferor had outstanding 1,294 shares of preferred stock of a total par value of $64,700, all of which had been issued prior to May 1, 1936 [the critical statutory date], and all of which were retired in 1939 (R. 67).

In assessing the deficiency for 1937, the Commissioner determined that the provision in the transferor's charter, incorporated by reference into its preferred stock certificates, which provision prohibited the payment of dividends on common stock so long as any of the preferred stock was outstanding, did not constitute a contract prohibiting the payment of dividends within the meaning of Section 26 (c) (1) of the Revenue Act of 1936 (R. 68). The Commissioner was sustained in the Tax Court, and the Circuit Court of Appeals, with one judge dissenting (R. 84–86), affirmed (R. 81–84).

SUMMARY OF ARGUMENT

I

The Revenue Act of 1936 levied a surtax on the undistributed net income of corporations, but pro-

vided for a credit based upon the portion of the corporate earnings which could not be distributed—

> without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. (Sec. 26 (c) (1).)

The petitioner considers that its transferor was entitled to this statutory credit for the year 1937, the claim being predicated upon Article V of the transferor's charter and upon the provision of its preferred stock certificates which incorporated that article by reference. The pertinent charter term provided in part:

> (c) The common stock shall be subject to the prior rights of the holders of the preferred stock as above declared and there shall be no dividend on the common stock until all of the preferred stock has been retired, redeemed and discharged.

During the taxable year, the transferor corporation had outstanding 1,294 shares of preferred stock, which stock was not fully retired until 1939.

The Government maintains that the Tax Court correctly sustained the Commissioner's disallowance of credit under Section 26 (c) (1) in computing the transferor corporation's undistributed profits tax for 1937, and that the majority of the

court below properly held such denial to be necessitated by this Court's opinion in the case of *Helvering* v. *Northwest Steel Mills,* 311 U. S. 46. Neither the transferor's stock certificates nor its corporate charter fulfilled the conditions to credit prescribed by Section 26 (c) (1). That Section, we think, is confined to contracts made with creditors and does not extend to restrictions imposed within the body corporate such as those now at bar. Moreover, the certificates in question did not "expressly" prohibit the payment of dividends within the meaning of the statute, nor was the transferor's charter an instrument "executed" by it as Section 26 (c) (1) requires.

The Circuit Courts of Appeals for the First and Sixth Circuits, and now for the Fifth, are in accord with the Government's position that the credit grant of Section 26 (c) (1) is limited to creditor contracts; the Third Circuit stands alone among the Circuit Courts of Appeals in holding that intracorporate agreements are "contracts" within the purview of Section 26 (c) (1). The Tax Court has always held the view that credit cannot be grounded on charter provisions; and it has also from the outset been the understanding of the Treasury that charter-imposed restrictions do not constitute a qualifying basis for credit under Section 26 (c) (1). Since rendition of the *Northwest Steel* decision the Tax Court and Treas-

ury have taken that view with respect to restrictions contained in stock certificates as well.

The legislative history illustrates that Section 26 (c) (1) was intended to be confined to routine contracts dealing with ordinary debts. Congress was interested in alleviating the hardship which the surtax imposed on corporations which found themselves contractually obligated to retain their earnings. If the restraint was imposed at the behest of creditors, there was little likelihood of its removal. If, however, the inability to pay dividends arose from commitments previously made to members of the body corporate, the corporation was in a better position to extricate itself from the surtax burden; an owner likely would, in the interests of the corporation, waive rights which a creditor would not.

Reference to the second paragraph of Section 26 (c) substantiates the view that Congress intended creditor obligations alone to afford foundation for credit under the first paragraph. Section 26 (c) (2) allowed credit in respect of earnings which a corporation was contractually obligated to pay or irrevocably to set aside for the discharge of debts. In Section 26 (c) (2) Congress expressly specified the nature of the obligation, and undoubtedly expected the two paragraphs to be read as *in pari materia*.

II

Assuming that internally-imposed restrictions are within the grace of the statute, the petitioner has still not made a case for preferential treatment. Section 26 (c) (1), as we have noted, provides specifically that the contract upon which reliance is placed shall be "executed" by the corporation. The petitioner must necessarily depend upon its transferor's charter, since there is no prohibitory provision in the certificates unless the pertinent charter term be read into them. A corporate charter is not a contract "executed" by the corporation, for the ordinary meaning of the word "executed", when used with reference to a written instrument, is "signed", or "signed, sealed, and delivered".

Section 26 (c) (1) also provides specifically that the contract relied upon must "expressly" deal with the payment of dividends. The necessity in the case at bar of referring to the charter in order to find any prohibition upon dividend payments in the stock certificates prevents considering those certificates as contracts "expressly" dealing with the payment of dividends.

ARGUMENT

Introductory.—This case presents the question of the proper construction of a portion of the undistributed profits tax law enacted by Congress as part of the Revenue Act of 1936, which imposed a surtax at graduated rates upon such of the

profits of corporations as were not distributed during the tax year by way of dividends. Revenue Act of 1936, Section 14, Appendix, *infra*, pp. 37–38. The major purposes of this levy, which was abandoned in the Revenue Act of 1938, were to equalize the tax burden on all corporate incomes whether distributed or not, and to prevent the avoidance of surtax by individual stockholders through the impounding of corporate profits in surplus. See H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 1–3 (1939–1 Cum. Bull. (Part 2) 667). The basis of the tax, as formulated in Section 14, was that portion of the "undistributed net income" of the corporation which was in excess of specified percentages of the "adjusted net income". Section 14 (a) defined "adjusted net income" as income less specified credits, and "undistributed net income" was declared to be the adjusted net income less the amount of the dividends paid during the tax year and less the credits provided in Section 26 (c), Appendix, *infra*, pp. 38–39. The latter Section was designed to afford relief from the surtax, in certain narrowly circumscribed situations, to corporations which were contractually prevented from distributing their profits. The measure provided in pertinent part:

> SEC. 26. CREDITS OF CORPORATIONS.
>
> In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—
>
> * * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. * * *

(2) *Disposition of profits of taxable year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrecovably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. * * *

It will be observed that paragraph (1) deals with negative restrictions preventing the distribution of earnings, and paragraph (2) deals with affirmative covenants by which earnings are irrevocably committed to the payment of debts. A more fundamental distinction between the two paragraphs is the manner in which the credit is computed, normally resulting in greater preference

where the corporation is obliged actually to pay out or irrevocably to set aside its earnings than where it is only negatively committed not to distribute them to its shareholders.*

The case at bar is specifically concerned with the proper interpretation and application of paragraph (1) of the foregoing Section. During 1937, the taxable year, petitioner's transferor corporation had outstanding 1,294 shares of preferred stock of a total par value of $64,700, all of which had been issued prior to May 1, 1936 (R. 67). Every preferred stock certificate carried the legend (R. 67)—

> For Rights and Voting Powers of Preferred Stock See Article V of Charter.

The pertinent part of Article V of the transferor's charter, to which this reference was made, read as follows (R. 65–66)—

> The Capital stock of this corporation is hereby fixed at 8,000 shares of no par value

* Under paragraph (2) the credit is equal to the amount of current earnings actually paid or set aside for the benefit of creditors. Under paragraph (1) account is taken of the earnings available for distribution, including accumulated earnings of prior years; and the credit is equal to the difference between this sum and the adjusted net income of the corporation. Thus a corporation subject merely to a negative restriction as to dividends payable out of current earnings may nevertheless be entitled to little or no credit under paragraph (1) if it has accumulated earnings of past years. See Regulations 94, Art. 26-2, Appendix, *infra*, pp. 39–42. Therefore the need for separate provisions was occasioned by the difference in the relief granted, rather than by a purpose to deal with fundamentally different corporate contracts.

> common stock and 400 shares of $50.00 par value of preferred stock,[2] which said stock shall be paid for in cash at the time of issuance or for service rendered or property actually received and shall be full-paid and nonassessable.
>
> The following rights, privileges and conditions shall attach to the shares aforesaid, viz:
>
> * * * * *
>
> (c) *The common stock shall be subject to the prior rights of the holders of the preferred stock as above declared and there shall be no dividend on the common stock until all the preferred stock has been retired, redeemed and discharged.* [Italics supplied.]
>
> * * * * *

The petitioner's derivative claim to credit under Section 26 (c) (1) rests upon the italicized language, *supra*. It is petitioner's thesis that inasmuch as the transferor's preferred stock was not fully retired until 1939 (R. 67), no dividend could have been paid during the taxable year upon the transferor's common without doing violence to this charter term which, incorporated by reference into the preferred share certificates, was allegedly:

> a provision of a written contract executed by the corporation * * * which pro-

[2] Article V was amended in 1935 to increase the authorized number of preferred shares from 400 to 1,400 (R. 66).

vision expressly deals with the payment of dividends. (Sec. 26 (c) (1).)

It is the Government's position, however, that neither stock certificates nor corporate charter fulfilled the conditions to credit prescribed by Section 26 (c) (1). We maintain in the first place that neither instrument evidenced the kind of "contract" intended by the Section to form the basis for the statutory credit; they dealt with intracorporate rights, whereas the statute is limited to agreements with creditors. In the second place, we submit that the stock certificates did not "expressly" deal with the payment of dividends as the statute requires for they only incorporated the pivotal term of the corporate charter by reference, and the charter itself was not "executed" by the corporation as prescribed by Section 26 (c) (1).

The statute at issue grants in effect an exemption from tax, and accordingly the familiar principle that exemption statutes are to be strictly construed is applicable. *Helvering* v. *Butterworth*, 290 U. S. 365; *Willcuts* v. *Bunn*, 282 U. S. 216; *Hughes Tool Co.* v. *Commissioner*, 147 F. 2d 967 (C. C. A. 5th); *Keystone Mut. Casualty Co.* v. *Driscoll*, 137 F. 2d 907 (C. C. A. 3d). Section 26 (c) has from inception been the subject of particularly strict construction in this Court, in all of the Circuit Courts of Appeals and in

the Tax Court.[5] Furthermore, a taxpayer who claims the privilege of preferred treatment by way of exemption has the burden of proving that his case plainly meets the spirit and the letter of the law. Cf. *White* v. *United States*, 305 U. S. 281; *New Colonial Co.* v. *Helvering*, 292 U. S. 435; *Helvering* v. *Magnus Beck Brewing Co.*, 132 F. 2d 379 (C. C. A. 2d).

In the Tax Court, denial of credit was principally based on that tribunal's view, held almost without deviation, that corporate charter and stock certificate provisions are not "contracts"

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[5] *Helvering* v. *Ohio Leather Co.*, 317 U. S. 102; *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46. Representative examples of Circuit Courts of Appeals and Tax Court "strict construction" decisions are: *Elliott Addressing Mach. Co.* v. *Commissioner*, 131 F. 2d 700 (C. C. A. 1st); *Buffalo Slag Co.* v. *Commissioner*, 131 F. 2d 625 (C. C. A. 2d); *Welsbach Eng. & Management Corp.* v. *Commissioner*, 140 F. 2d 584 (C. C. A. 3d), certiorari denied, 322 U. S. 751; *Antietam Hotel Corp.* v. *Commissioner*, 123 F. 274 (C. C. A. 4th); *Commissioner* v. *Dulup Oil Co.*, 126 F. 2d 1019 (C. C. A. 5th); *Warren Tel. Co.* v. *Commissioner*, 128 F. 2d 503 (C. C. A. 6th), certiorari denied, 317 U. S. 697; *Commissioner* v. *E. C. Atkins & Co.*, 127 F. 2d 783 (C. C. A. 7th); *Helvering* v. *Moloney Electric Co.*, 120 F. 2d 617 (C. C. A. 8th), certiorari denied, 314 U. S. 682; *Guanacevi Mining Co.* v. *Commissioner*, 127 F. 2d 49 (C. C. A. 9th); *Atlas Supply Co.* v. *Commissioner*, 123 F. 2d 356 (C. C. A. 10th); *Staley Manufacturing Co.* v. *Commissioner*, 46 B. T. A. 199; *Eaton Paper Corp.* v. *Commissioner*, 1 T. C. 1; *Dr. Pepper Bottling Co.* v. *Commissioner*, 45 B. T. A. 540; *Campbell Transportation Co.* v. *Commissioner*, 43 B. T. A. 417.

within the purview of Section 26 (c) (1).[4] That view was also the primary basis for the decision of the Circuit Court of Appeals herein (R. 83–84), and the point to which the dissenting member of the court voiced exception (R. 85–86).[5] And since it is upon that point that the opinion of the Circuit Court of Appeals for the Third Circuit[6] differs from that expressed by the majority below and by other Circuit Courts of Appeals which have passed on the question,[7] we propose in Part I to substantiate our position that neither stock certificates nor corporate charters evidence the kind of contract upon which a claim to the statutory credit may properly be founded. For the purpose of that discussion, we shall assume that, within the meaning of Section 26 (c) (1), the transferor's charter was "exe-

[4] Dicta to the contrary in respect of stock certificates, which appeared in *Airtherm Mfg. Co.* v. *Commissioner*, 43 B. T. A. 736, were expressly repudiated in the case of *Bishop & Babcock Manufacturing Co.* v. *Commissioner*, 45 B. T. A. 776, affirmed, 131 F. 2d 222 (C. C. A. 6th), remanded to the Tax Court on another issue, 133 F. 2d 199.

[5] Both majority and minority appear to have understood (R. 83, 85) that petitioner was relying solely upon its transferor's stock certificates which incorporated the pertinent charter provision only by reference.

[6] The Court of Claims is in accord with the Third Circuit. *Rex-Hanover Mills Co.* v. *United States*, 53 F. Supp. 235.

[7] *Lehigh Structural S. Co.* v. *Commissioner*, 127 F. 2d 67 (C. C. A. 3d); cf. *Warren Tel. Co.* v. *Commissioner*, 128 F. 2d 503 (C. C. A. 6th), certiorari denied, 317 U. S. 697; *Elliott Addressing Mach. Co.* v. *Commissioner*, 131 F. 2d 700 (C. C. A. 1st).

cuted" by the corporation and that its stock certificates "expressly" dealt with the payment of dividends. Demonstration of the fallacy of these assumptions will follow in Part II.

I

THE STATUTE CONTEMPLATES CONTRACTS WITH CREDITORS AND NOT RESTRICTIONS IMPOSED WITHIN THE FRAMEWORK OF THE CORPORATION ITSELF

In 1940, this Court passed in companion cases upon the claims to credit under Section 26 (c) (1) (Appendix, *infra*, p. 38) of two corporations whose domiciliary laws forbade dividend distributions during the existence of a corporate deficit. *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46; *Crane-Johnson Co.* v. *Helvering*, 311 U. S. 54. The claimants were deficit corporations, and they argued, *inter alia*, that the prohibitory state law was an implied-in-law provision of their corporate charters, which were "contracts" within the meaning of the federal statute. The Court, rejecting both claims, declared in the *Northwest Steel* case (pp. 48, 50–51)—

> The only "written contract executed by the corporation" upon which respondent relies for its claimed exemption is its corporate charter, granted by the State of Washington. * * *
>
> * * * * * *
>
> It is true * * * that a charter has been judicially considered to be a contract insofar as it grants rights, properties,

> privileges, and franchises. * * * But it does not follow that Congress intended to include corporate charters and related state laws in the cautiously limited area permissible for tax credits and deductions under this section. * * *

Mr. Justice Black, who spoke for the Court in *Northwest Steel* case, drew attention to the fact that the second paragraph of that Section (Appendix, *infra*, p. 38) expressly conditions credit upon the existence of an obligation to set earnings aside for the payment of corporate debts. He then stated (p. 50)—

> That this section [Section 26 (c) (2)] referred to routine contracts dealing with ordinary debts * * * is obvious—yet the words used to indicate that the section had reference only to a "written contract executed by the corporation" are identical with those used in Section 26 (c) (1). There is no reason to believe that Congress intended that a broader meaning be attached to these words as used in Section 26 (c) (1) than attached to them under the necessary limitations of 26 (c) (2).

Thus, as to the kind of contract embraced and the formalities required, this Court has stated that there is complete identity between the two paragraphs of the statute. Each paragraph deals with, and is confined to, routine contracts dealing with ordinary debts which have been executed in writing by the claimant corporation. And as we have pointed out above, it is the difference in the

tax through the difference in the credit computation which essentially differentiates paragraphs (1) and (2) of Section 26 (c).

The Circuit Courts of Appeals for the Sixth and First Circuits and now for the Fifth, as witness this case, have taken the *Northwest Steel* decision to mean precisely what it says—that Section 26 (c) is limited in both paragraphs to routine contracts dealing with ordinary debts. *Warren Tel. Co.* v. *Commissioner*, 128 F. 2d 503 (C. C. A. 6th), certiorari denied, 317 U. S. 697; *Metal Specialty Co.* v. *Commissioner*, 128 F. 2d 259 (C. C. A. 6th); *Bishop & Babcock Manufacturing Co.* v. *Commissioner*, 131 F. 2d 222 (C. C. A. 6th), remanded to the Tax Court on another issue, 133 F. 2d 199; *Elliott Addressing Mach. Co.* v. *Commissioner*, 131 F. 2d 700 (C. C. A. 1st). The Circuit Court of Appeals for the Third Circuit stands alone among the Circuit Courts of Appeals in holding that the *Northwest Steel* case does not bar intra-corporate agreements as "contracts" within the purview of Section 26 (c) (1). That court early determined that stock certificates, which reiterated a charter provision setting up a sinking fund for retirement of the corporation's preferred shares and expressly prohibiting dividends to other classes until the preferred had been discharged, was a "contract" provision under the statute. *Lehigh Structural S. Co.* v. *Commissioner*, 127 F. 2d 67. The court read (pp. 68–69) the *Northwest Steel* decision as meaning only that restrictive provisions imposed by state law and contained in charter and

stock certificates merely by implication are not sufficient under the statute; and the *Lehigh* case has several times been applied in the Third Circuit[8] to overrule Tax Court decisions which have expressed the view of that body that the *Northwest Steel* case has the broader connotations which the Sixth, First, and Fifth Circuits have given it.

The *Lehigh* case was decided prior to the time when the Circuit Court of Appeals for the Sixth Circuit was called upon to consider the question whether a taxpayer was entitled to Section 26 (c) (1) credit on the basis of amended articles expressly providing that cumulative dividends on its preferred stock should be payable out of surplus or net profits before any dividend on common stock should be paid. *Warren Tel. Co.* v. *Commissioner*, 128 F. 2d 503, certiorari denied, 317 U. S. 697. Expressly declining to accept the Third Circuit's limited interpretation of the *Northwest Steel* decision, the Sixth Circuit took the position that the language of that opinion necessitated confining the credit of Section 26 (c) to "routine contracts dealing with ordinary debts," the terminology used in that case. Agreements within the body corporate represented in charter and certificate provisions are not, the court said in the *Warren Tel.* case (p. 506), the kind of contract contemplated in Section 26 (c) (1) as

[8] See *Eljer Co.* v. *Commissioner*, 134 F. 2d 251; *Budd International Corp.* v. *Commissioner*, 143 F. 2d 784, certiorari denied, 323 U. S. 802; *Philadelphia Record Co.* v. *Commissioner*, 145 F. 2d 613.

the basis for the limited-credit grant of that Section. Speaking at length of the *Lehigh* decision, the *Warren Tel.* opinion states (p. 506):

> This view is not in accord with that of the Third Circuit Court of Appeals in *Lehigh Structural Steel Co.* v. *Commissioner* [citation omitted]. The court there reasoned that while it was logical to exclude from within the connotation of contract as the term is used in Section 26 (c) (1), a charter or stock certificate which contains no restraint upon the payment of dividends and may be so interpreted only by reading into it state law, it does not follow that a charter or certificate which expressly restrains payment of dividends may not be a written contract within the meaning of the section. In our view, the rationale of the *Northwest Steel Rolling Mills* case is broader than that. The Lehigh case overlooks the interpretation that the section refers "to routine contracts dealing with ordinary debts". Having in mind its legislative history and the apparent purpose of the Congress to exempt corporations from the imposition of the tax upon deferred dividends only when the corporation has put it beyond its power to declare them by prior contract obligation to creditors (not stockholders), we hold the present issue to be controlled by the *Northwest Steel Rolling Mills* case.

The First Circuit too, as we have stated, has not been impressed with the narrow reading of the

Northwest Steel opinion given by the Third Circuit in the *Lehigh* case. *Elliott Addressing Mach. Co.* v. *Commissioner*, 131 F. 2d 700. In the *Elliott* case, the court rejected a claim to credit under Section 26 (c) (1) which was based upon a charter provision requiring the purchase of certain stock before paying dividends to any class except first preferred. The *Warren Tel.* case was approved by the First Circuit, the opinion stating (p. 702)—

> From our reading of *Helvering* v. *Northwest Steel Mills* [citation omitted], we are of the opinion that the court intended to go farther than the specific facts in that case and that it excluded charter provisions from Section 26 (c) (1).

The court thereupon quoted (p. 702) the language from the *Northwest Steel* opinion to which we have heretofore adverted—that while a corporate charter is for some purposes a contract, it does not follow that Congress intended to include corporate charters in the cautiously limited area for tax credits and deductions under Section 26 (c) (1).[9]

[9] In the *Elliott* case, the stock to be purchased had been issued to cover a loan to the corporation, and there was some question whether the critical charter covenant had entirely superseded the contract with the creditor which had preceded adoption of the charter provision. As to this facet of the case, the court said (pp. 702–703)—

> Even if we were to say that the charter amendment of 1934 did not entirely supersede the original contracts, it cannot be denied that to the extent the char-

The decision of the Circuit Court of Appeals for the Second Circuit in *Monarch Theatres* v. *Helvering*, 137 F. 2d 588, is not contrary to our position (cf. Br. 18–19). The court there held, *inter alia*, that the resolution of directors with respect to the purchase of certain theatre shares and containing a condition that no dividends be paid until the corporate indebtedness for the purchase price be reduced to a sum stated, was, when taken with the offer, a "written contract executed by the corporation" within the meaning of Section 26 (c) (1). But the resolution in the *Monarch Theatres* case had to do with a creditor obligation; and the court took careful note (p. 590) of the fact that the *Lehigh* case stood alone in holding that a provision in a share certificate and charter made for the protection of a group of shareholders would protect the corporation under Section 26 (c) (1). The court said (p. 590):

> * * * we need not hold that the mere fact that the corporate promise is in the form of a resolution, or indeed of a by-law or a charter provision, need make it nugatory. That should depend upon whether the resolution—and perhaps also a by-law

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ter amendment fundamentally changes the contracts, reliance must be placed upon it. Under the language of *Helvering* v. *Northwest Steel Mills*, *supra*, and the * * * cases which we have cited in its support, we find no justification in drawing a distinction between those cases involving merely a charter provision and the case at bar.

> or a charter provision—does, or does not, contain a complete contract * * *. If it does not, it will not be within Section 26 (c) (1), *even though it may have been intended to be acted upon by creditors, and though creditors have acted in reliance upon it.* * * * [Italics supplied.]

Except for the fact that the common stock certificates themselves contained the restriction against dividends, the Court of Claims' decision in *Rex-Hanover Mills Co.* v. *United States*, 53 F. Supp. 235, is in direct conflict with our position here. That court reasoned in primary part (p. 246) that the May 1, 1936, execution date deadline of Section 26 (c) (1) afforded sufficient protection against the making of restrictive agreements for the purpose of avoiding the surtax, and that Section 26 (c) (1) therefore did not need to be given such construction as would serve to confine its benefits beyond what the court thought to be justified by its words. The court further disapproved (p. 245–246) the reliance of the then Board of Tax Appeals in *Metal Specialty Co.* v. *Commissioner*, 43 B. T. A. 891, affirmed, 128 F. 2d 259 (C. C. A. 6th), and of the Circuit Court of Appeals for the Sixth Circuit in the case of *Warren Tel., supra*, on the restrictive phrase "routine contracts dealing with ordinary debts" which was used by this Court in the *Northwest Steel* decision; the Court of Claims thought this Court could (p. 246) "hardly have intended to

read into 26 (c) (1) a limitation of the written agreements there mentioned to agreements with creditors, when the Court's language was directed to Section 26 (c) (2)", which dealt only with agreements to discharge "debts". If the execution dead-line were the effective "preventative" which the Court of Claims considered it to be with regard to Section 26 (c) (1), it should have been made to serve without need of further support equally in respect of Section 26 (c) (2) where it likewise appears. We think, further, that the Court of Claims failed sufficiently to consider the fundamental parallelism between the two paragraphs—the difference being, as previously discussed, the grant of a differently computed credit where the obligation was only to retain earnings for the ultimate protection of creditors than where the undertaking was actually to pay or to earmark earnings for the immediate discharge of debts.

It is submitted in any event that the Court of Claims and the Third Circuit erred in holding that Section 26 (c) (1) contemplates restrictions imposed within the corporate framework. The contrary view is fortified by the history of litigation on this point in the Tax Court as well as in the other circuits. The Tax Court has from the statute's inception held, with only such deviation as we have heretofore noted (notes 3, 4, *supra*), that agreements made within the body corporate expressed in charter or stock certificate provisions, are not the type of contract which Congress in-

tended to form a basis for the preference treatment given in Section 26 (c) (1).[10] Furthermore, it has from the outset been the understanding of the Treasury that charter-imposed restrictions do not constitute a qualifying basis for credit under Section 26 (c) (1). See T. D. 4674, XV–2 Cum. Bull. 53 (1936). See also Article 26–2 of Treasury Regulations 94, promulgated under the Revenue Act of 1936, Appendix, *infra*, p. 40.[11] As this Court many times has said, the contemporaneous interpretation of a statute by the officials charged with its administration is entitled to great weight and ought not to be disturbed except upon major considerations, especially where the interpretative ruling has been consistent and long-standing. *Overnight Motor Co.* v. *Missel*, 316 U. S. 572; *Norwegian Nitrogen Co.* v. *United States*, 288 U. S. 294; *Brewster* v. *Gage*, 280 U. S. 327; cf. *Miller Hatcheries* v. *Boyer*, 131 F. 2d 283 (C. C. A. 8th).

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[10] The Tax Court continued to maintain this position even after it became evident that it courted continual reversal on the authority of the *Lehigh* case should appeal lodge in the Circuit Court of Appeals for the Third Circuit. *E. g.*, *Eljer Co.* v. *Commissioner*, decided December 4, 1941 (1941 P–H B. T. A. Memorandum Decisions, Par. 41,533); *Budd International Corp.* v. *Commissioner*, 45 B. T. A. 737; *Philadelphia Record Co.* v. *Commissioner*, decided January 23, 1943 (1943 P–H T. C. Memorandum Decisions, Par. 43,038).

[11] This article states specifically that—

> * * * The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). * * *

It is true that the Bureau of Internal Revenue originally ruled that stock certificates issued before May 1, 1936, which contain an express provision restricting dividend payments, satisfy the requirements of Section 26 (c) (1). I. T. 3109, 1937–2 Cum. Bull. 111; I. T. 3152, 1938–1 Cum. Bull. 155. However, the Bureau promptly revoked its ruling following rendition of the *Northwest Steel* decision,[12] such revocation being undoubtedly inspired by this Court's statement in that opinion (p. 52, fn. 17)—

> Respondent contended that the stock certificates satisfied the statutory requisites even if the charter did not; but what we have here said with respect to the charter applies equally to the certificates.

Thus the Bureau also has proceeded since the *Northwest Steel* decision upon an understanding of that case as foreclosing stock certificates along with corporate charters from the grace of the congressional grant found in the statute under consideration.

The clear weight of authority, administrative and judicial, then, is contrary to petitioner's contention. But if this Court intended to reserve the question and was merely speaking discursively when it used the language upon which such extensive reliance has been placed, we feel nevertheless certain that our position is sound as an original proposition. In the statements made by mem-

[12] I. T. 3525, 1941–2 Cum. Bull. 188.

bers of Congress when the 1936 Act was under consideration, there is ample evidence to support our contention that the Legislature intended the credit allowance of Section 26 (c) (1) to be founded on agreements with corporate creditors and not on restrictions imposed within the corporate framework. Thus, Representative Samuel B. Hill, Chairman of the Subcommittee on Taxation of the Committee on Ways and Means, remarked (80 Cong. Rec. 6004):

> If a corporation as of March 3, 1936, finds itself in a position, *by reason of a contract entered into with its creditors,* not to pay dividends until it has paid its creditor his debt or has established a sinking fund, or otherwise provided means of paying the obligation, if it is under that handicap by reason of a written contract, then we allow the corporation a 22½ percent flat rate on that portion of the net income which it is unable to pay out, by reason of this contract, in dividends. [Italics supplied.]

Another member of the subcommittee, Representative Fred Vinson, stated (80 Cong. Rec. 6212):

> Moneys are obtained upon expressed promises that dividends will not be declared until the loan and interest is repaid in whole or in part. The committee recognizes the position in which the taxpayer is placed. * * *

Obviously the reason thus expressed for exemption from tax does not obtain where the restric-

tions are internally imposed. Nor, where such is the case, is the corporation ordinarily "placed in a position" from which it cannot extricate itself as is the case where the contract is creditor-imposed. To be sure, preferred stockholders may be reluctant to relinquish their special rights. But in the ultimate their interest is that of a proprietor in the business, and concern for its fortunes may prompt concessions which a creditor who is to be paid his principal and interest at all events, would not make. If it appears that a heavy tax burden will hamper the corporation's operations, it is reasonable to assume that those shareholders will not stand on rights which are obstacles to alleviation of the hampering condition. A creditor, not thus motivated, can afford to and usually would be adamant. This last, we believe, is the "position in which the taxpayer is placed" which the committee "recognized" when it afforded the exemption.

It is significant too that Congress should have used precisely the same words in both paragraphs of the Section to describe the contract—"a written contract executed by the corporation." Congress certainly expected paragraph 1 of the Section to be read in context. See *Commissioner* v. *Bristol*, 121 F. 2d 129 (C. C. A. 1st). And there could be no rational purpose in confining to the discharge of creditor obligations the paragraph dealing with actual payment or earmarking if it were not intended similarly to circumscribe the para-

graph dealing with mere arrangements for payment *in futuro* by way of retention of corporate earnings. The petitioner could have claimed no credit under Section 26 (c) (2) had it actually redeemed its preferred stock during the taxable year, for a corporation is not "indebted" to its shareholders. *Warren* v. *King*, 108 U. S. 389. There would therefore seem no sound ground for it now receiving preferential treatment under Section 26 (c) (2) by reason, in effect, of postponing redemption. We think it must be assumed that Congress advisedly used the same words in both paragraphs to describe the same kind of contract.[13]

II

THE CHARTER WAS NOT A CONTRACT "EXECUTED" BY THE TRANSFEROR CORPORATION NOR DID ITS STOCK CERTIFICATES "EXPRESSLY" DEAL WITH THE PAYMENT OF DIVIDENDS

The decision below is plainly entitled to affirmance if we are correct in maintaining that Section

[13] It should be noted that the Third Circuit held that a stock certificate provision similar to that in the instant charter does not actually prohibit the payment of dividends but is merely an intracorporate agreement as to priorities in their payment. *Budd International Corp.* v. *Commissioner*, 143 F. 2d 784, 793, certiorari denied, 323 U. S. 802. However, under the statute, there must be a contract which actually operates as a legal compulsion to retain earnings. See *Welsbach Eng. & Management Corp.* v. *Commissioner*, 140 F. 2d 584 (C. C. A. 3d), certiorari denied, 322 U. S. 751; *Mastin Realty & Min. Co.* v. *Commissioner*, 130 F. 2d 1003 (C. C. A. 8th); *Helvering* v. *Magnus Beck Brewing Co.*, 132 F. 2d 379 (C. C. A. 2d); *Clover Splint Coal Co.* v. *Commissioner*, 130 F. 2d 52 (C. C. A. 3d); *Buffalo Slag Co.* v. *Commissioner*, 131 F. 2d 625 (C. C. A. 2d).

26 (c) (1) credit is limited to agreements made with creditors of the claimant corporation. There are in our judgment other reasons, however, why the petitioner does not qualify under the statute.

(a) Section 26 (c) (1) provides specifically that the contract upon which reliance is placed shall be "executed" by the corporation. The petitioner relies in part upon its transferor's stock certificates but necessarily it must depend in the ultimate upon the charter, since there is a provision dealing with dividends in the certificates only if the pertinent charter term be read into them, and since it is the charter rather than the certificates which create the stockholders' rights. Accordingly, we think, any inadequacy under Section 26 (c) (1) inhering in the charter must of necessity adhere to the certificates,[14] and we submit that a further inadequacy of the charter beyond that previously discussed is that it was not a contract "executed" by the corporation within the meaning of the statute.

The ordinary meaning of the word "executed", when used with reference to a written instrument, is "signed" or "signed, sealed and delivered". I Bouvier's Law Dictionary (Rawles' Third Revision) 1111; 15 Words and Phrases, 551–553 (Perm. ed.). And, since there is no indication that Congress intended the word "execution" to

[14] Cf. *Elliott Addressing Mach. Co.* v. *Commissioner*, 131 F. 2d 700 (C. C. A. 1st); *Caroline Mills* v. *Commissioner*, 126 F. 2d 857 (C. C. A. 5th).

have here a particular or different meaning, it seems clear that Section 26 (c) (1) applies only to a written contract which the corporation has signed in ordinary course. Corporate charters are secured through the filing of articles of incorporation by individuals desiring to incorporate and by the issuance of a certificate of incorporation by the state. The corporation itself has no existence until the certificate is issued, and it obviously does not execute the articles of incorporation.[15] Nor does the situation differ fundamentally where, as here, we are concerned as well with amended articles. True, the corporation is in existence while its amended articles are pending acceptance by the state, and it is the corporate officers or directors who sign the application to amend on the corporate behalf. But it seems to us that if Congress did not intend the original

[15] The requirement that the contract must be "executed by the corporation" has a bearing also upon the argument made in part I of this brief—that the statute contemplates contracts with creditors, not intra-corporate restrictions. It is the corporate charter, an instrument not executed by the corporation, which creates and defines the rights and priorities of the several classes of shareholders *inter se*. The issuance of stock certificates merely furnishes additional evidence of the existence of rights which lodge in the charter. If no certificates were issued reiterating the charter provisions, the stockholders' rights would be no less; and they are no greater by being so repeated. Congress was not thinking, we submit, of charter provisions defining the rights of shareholders, or of stock certificates repeating those provisions, when it required in Section 26 (c) (1) that the provision restricting dividends must be contained in a contract "executed by the corporation".

charter to be considered a contract "executed" by the corporation, there could be little reason in accepting as a basis for credit amended articles merely by reason of their being amended. The process of amendment is no different fundamentally than the process of initiation, or certainly it should not be so regarded for the purpose of the federal revenue laws.

This Court said in the *Northwest Steel* case (311 U. S. 46, 49):

> The natural impression conveyed by the words "written contract executed by the corporation" is that an explicit understanding has been reached, reduced to writing, signed and delivered.

Quite obviously, these words do not describe the act of a corporation in filing articles either of incorporation or of amendment; that act is in the nature of a supplication to the state. In *Atlas Supply Co.* v. *Commissioner*, 123 F. 2d 356 (C. C. A. 10th), the court refused credit under Section 26 (c) (1) where the "contract" relied on was a provision of the by-laws prohibiting dividend distributions which would impair capital. The by-law was not, the court said (p. 357), a contract formally executed by the corporation such as the statute plainly requires.[16] The same conclusion was reached by the Circuit Court of Appeals for the Fifth Circuit in respect of a stockholders'

[16] See also *Commissioner* v. *Columbia River P. M.*, 127 F. 558 (C. C. A. 9th).

resolution reciting an oral agreement between bondholders' and stockholders' committees wherein the stockholders agreed not to pay out dividends until past due bond interest had been met, the resolution being subsequently approved by the corporation's board of directors. *Caroline Mills* v. *Commissioner*, 126 F. 2d 857. The court there adopted the Commissioner's position that the resolution was not in the form of a contract and was not properly executed as a contract by the corporate officers.

In *Mastin Realty & Min. Co.* v. *Commissioner*, 130 F. 2d 1003 (C. C. A. 8th), a creditor offered to make loans to the corporation if it would pay no dividends until he was reimbursed. The corporation accepted the money and thereafter spread upon the minutes a resolution signed by its directors to the effect that all money borrowed should be paid in full before distribution of any dividends. The court held that the resolution did not satisfy the statute, *inter alia* because it was not on its face a formal contract but only a declaration of corporate policy. The court remarked (p. 1005), that the resolution was not signed by the corporation or by any of its officers and hence was not "executed"; the minutes were signed, but they gave no indication of being intended as anything more than a record of what transpired at the directors' meeting. The court said (p. 1006):

> We need not consider whether * * * [the creditor] could hold the corporation

> to a contract as evidenced by his letter and the resolution and acts under them because more than that is required here. A written contract specifically dealing with the payment of dividends must have been executed by the corporation.

Here, too, it is immaterial whether the transferor corporation's charter represented an enforcible agreement, because more than that is required under Section 26 (c) (1). A written contract dealing with the payment of dividends must have been "executed" by the corporation, and the charter upon which the petitioner must in final analysis rest its case does not fulfill that requirement.

(b) Section 26 (c), (1) also provides specifically that the contract relied upon must "expressly" deal with the payment of dividends. Even if we should consider that the stock certificates here were contracts of the class intended, and that they were contracts "executed" by the corporation when read together with the "unexecuted" charter—as necessarily they must be—they still would not answer the statutory conditions because the very necessity of referring to the charter in order to find any prohibition upon dividends prevents considering the certificates as contracts "expressly" dealing with the payment of dividends. In the *Northwest Steel* case, where

in rejecting the contention that claim to credit could rest upon an implied-in-law term of restriction, this Court said (p. 49):

> True, obligations not set out at length in a written contract may be incorporated by specific reference, or even by implication. But Congress indicated that any exempted prohibition against dividend payments must be expressly written in the executed contract. It did this by adding a precautionary clause that the granted credit can only result from a provision which "expressly deals with the payment of dividends".

This language is clear indication, we think, that the Court did not believe that such common-law concepts as the doctrine of incorporation by reference were available to a claimant "in the cautiously limited area permissible for tax credits" (311 U. S. at p. 51) under this Section.[17]

[17] Such cases as *Glenn* v. *Chess & Wymond*, 132 F. 2d 621 (C. C. A. 6th); *Automotive Parts Co.* v. *Commissioner*, 134 F. 2d 420 (C. C. A. 6th), and *Monarch Theatres* v. *Helvering*, 137 F. 2d 588 (C. C. A. 2d) are perhaps authority pointing *contra*. In those cases incorporation by specific reference was not involved, but the credit was allowed on restrictive agreements spelled out by reading several instruments together. Those cases were chiefly concerned, however, with whether or not there was a complete contract and not with whether the prohibition against dividends in the instrument relied upon was "express". And cf. *Budd Wheel Co.* v. *Commissioner*, 45 B. T. A. 963.

CONCLUSION

For the foregoing reasons, the decision of the court below should be affirmed.

Respectfully submitted.

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APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of

20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

(c) *Adjusted Net Income Less Than $50,000.*—

(1) *Specific credit.*—If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).

(2) *Application of specific credit.*—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:

(A) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(B) 7 per centum of the amount of the specific credit.

* * * * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate

of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of profits of taxable year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

* * * * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26-2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c)

with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both section 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same,

only one of such paragraphs shall be applied.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly

deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

The term "debt" as used in section 26 (c) (2) does not include an obligation of the corporation to a shareholder, as such, as distinguished from a creditor. Accordingly, amounts paid into, or set aside for, a sinking fund by a corporation for the retirement of preferred stock, pursuant to the terms of an agreement underlying the preferred stock issue, shall not be considered as set aside for discharge of a debt. An indebtedness evidenced by bonds or other similar obligations issued by a corporation is incurred as of the date such obligations are issued, and the amount of such indebtedness is the amount represented by the face value of the obligations. For the purpose of this article a bond or other similar obligation is not issued until it is executed and delivered to a person who holds it as a debt of the corporation. Bonds issued after April 30, 1936, in exchange in refunding a preexisting issue represent debts incurred after April 30, 1936, within the meaning of section 26 (c) (2).

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945

No. 93

HERCULES GASOLINE COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR REHEARING

MELVIN F. JOHNSON,
Counsel for Petitioner.

JOSEPH H. JACKSON,
Of Counsel for Petitioner.

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SUPREME COURT OF THE UNITED STATES

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REHEARING

To the Honorable Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Comes now Hercules Gasoline Company, Inc., petitioner in the above entitled cause, and presents this, its petition, for a rehearing in the above entitled cause and, in support thereof, respectfully shows:

I

The Court erred in its decision and judgment rendered December 17, 1945, in holding that the taxpayer, although bound not to distribute earnings, was not bound by the kind of contract the Court thought necessary.

The law plainly says corporations shall be given credit for a written contract which prohibits dividends.[1] Congress

[1] The history of this legislation shows that the bill as introduced in the House contained Sec. XX which gave credit when the corporation "has made a bona fide contract not to pay dividends *or* not to pay out as dividends a stipulated portion of its earnings and profits for the taxable

did not confine the contracts to those made with creditors. In effect, the Court is writing this requirement into the statute. The Court is entering the legislative field. Supplying this omission transcends the judicial function of this Court. The Court has established landmarks directly to the contrary.[2] When a law is free and clear of ambiguity, the letter of the law should not be disregarded under the pretext of pursuing its spirit!

In this connection, the majority opinion states that we contended that your construction of Sec. 26(c)(1) was erroneous in the *Northwest Steel* case. This is error. We have never made this contention. We *have* contended as forcefully as we know how that the *Northwest Steel* case was not apposite to our case and that the Fifth Circuit erred in basing its decision on it. Furthermore, we stated to Mr. Justice Black in oral argument that we thought the Northwest Steel decision was correct on the facts of that case and under the law as it stood at that time.

II

The Court erred in finding support for construing Sec. 26 (c) (1) as confined to creditor-debtor contracts by a consideration of Sec. 26 (c) (3).

Many small corporations, like this taxpayer in 1933, in the late depression period were effectively prevented from

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year." See Rev. Act, 1936. Hearings before Ways and Means Committee, House of Representatives, p. 10 and 62.

The Commissioner (Mr. Helvering) stated the purposes of the legislation (Same, p. 19-20-22) and disclaimed any intention to interfere with the internal management of business enterprises.

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[2] *Iselin* vs. *U. S.*, 270 U. S. 245, 250, 251; 70 L. Ed. 569.
Sabine Tr. Co. vs. *Com.*, 318 U. S. 306; 87 L. Ed. 776.
Helvering vs. *Credit Alliance Corp.*, 316 U. S. 112; 86 L. Ed. 1312, holding with reference to the same law: "But whatever may be said of the policy behind the statute's provisions, we are not at liberty to disregard the direct and unambiguous language of subsection (f)."

distributing dividends by agreements with investors, preferred stockholders, banks and furnishers of material. It is a customary way to get small companies started. Section (3) merely states that if *both* paragraphs (1) and (2) apply, *the one of such paragraphs which allows the greater credit* shall be applied and if the credit under each paragraph is the same, *only one shall be applied.* The language "if the credit *allowable under each paragraph* is the same" impels the inference that at least two kinds of contract credit are included.[3] Thus the statute necessarily brings within its provisions instances of restrictions against dividends by contracts with investors as well as similar prohibitions by contracts with creditors. If there were two contracts and thus *both* credits were applicable, the larger should be applied. Either "kind" of contract would make the corporation unable to distribute earnings. The unavoidable implication is that more than one *"kind" of contract* is intended because Sec. 26(c)(3) brings about a comparison of and a separation between the two kinds and credit is ordered to *one or the other*, whichever is greater. Subdivisions (1) and (2) lay down the bases of credit and subdivision (3) measures one against the other to avoid duplication. Thus, the more reasonable result from a consideration of subsection (3), it seems to us, is directly contrary to the conclusion arrived at by the Court.

If Congress meant that only contracts with creditors should receive credit, *why did Congress write Sec. 26 (c) (1) into the enactment?* Why give this provision first place in the Section relating to credits?

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[3] This interpretation is further emphasized by the recurrence of the word "debt" four times in subsection (2) and its total absence in subsection (1). See Brief for Petitioner, p. 26-7.

III

The Court is wrong in its holding that the taxpayer's contract with its preferred stockholders was an intra-corporate agreement to keep profits in the corporation's treasury so that the tax collector could not reach them and then adding in the footnote (4) that petitioner might have redeemed the preferred stock issue in 1937.

In the very beginning of this controversy, the Commissioner only made the point that *the preferred stock certificates did not constitute a contract.* When the matter was tried in the Tax Court, petitioner's counsel approached proof of good faith and the corporation's inability to pay off the preferred stock in 1937, considering a large mortgage indebtedness and a lack of cash, whereupon counsel for the Government objected and stated that the issues did not include any question about the financial ability of the corporation to remove the restriction and pay dividends (R. 48-49). In the Tax Court, in the Fifth Circuit and in this Court, counsel for the Government have scrupulously stayed off this ground, conceding that the withholding of dividends was not wilful. In raising this question now, the Court should give us an opportunity to meet this new argument.

A holding that the stock certificate restriction here was intra-corporate was manifestly error because we have a situation where *outside persons were induced to purchase preferred stock* on the strength of *bona fide* representations that the common stockholders would receive no dividends until the preferred stock was retired (R. 67). These holders of preferred were a different set of stockholders! The intra-corporate theory falls when confronted with the facts in this case. This corporation was owned by its common stockholders. The corporation, on the one hand, contracted with its preferred stockholders (who had no vote

or notice of meetings), on the other hand, that the owners would get none of the profits until the preferred stockholders were paid off. The corporation had no real opportunity to keep its profits in the treasury, away from the tax collector. It was prevented by a series of binding contracts with outside people. *It had absolutely no choice to distribute profits to avoid the tax.*

The whole idea of the undistributed profits tax was not so much a tax as it was a penalty on those who deliberately chose not to distribute profits! It was aimed at accumulations of surplus. (See history above.) And this taxpayer, being bound by contract, had no choice in the matter. It was caught in a trap. The judgment of this Court that petitioner "was keeping profits in its treasury" is particularly severe.

IV

The Court erred assuming for purposes of argument that Sec. 26 (c) (1) only covered contracts made with creditors, in not finding that this contract with preferred stockholders was a "routine contract dealing with ordinary debts."

When these parties bought preferred stock, they became creditors of the corporation. There was nothing extraordinary about this. The arrangement *was* a routine contract dealing with ordinary debts. The certificates were written contracts expressly dealing with the payment of corporate debts. The Record shows, as a matter of fact, that some of the persons who acquired the preferred stock were creditors and some were investors (R. 31-36; 67). After acquisition, they were all creditors who received a guaranteed return and who might be paid off any time on 30 days notice.

We sincerely believe Your Honor's decision is out of harmony with the great precedents established by this Court. We note that the case was decided ten days after

submission and by a divided Court. Since the issues involve rights vested in contract, a subject matter which was the concern of the framers of our Constitution, and being convinced that the Court will wish to review cases where there may be doubt as to the correctness of its decision, we humbly plead for a rehearing. We conceive it to be our duty to ask for a rehearing that this Court may avoid a bad precedent, where the Court amended a legislative enactment, where it disregarded principles established in the high jurisprudence of this Court and nation and where it has overlooked certain significant facts of the case under review.

Wherefore, upon the foregoing grounds, it is respectfully urged that the petition for a rehearing be granted and that the judgment of the Fifth Circuit be upon further consideration reversed.

Respectfully submitted,

MELVIN F. JOHNSON,
Counsel for Petitioner,
Hercules Gasoline Company, Inc.
JOSEPH H. JACKSON,
Of Counsel for Petitioner.

Certificate of Counsel

I, counsel for the above named Hercules Gasoline Company, Inc., do hereby certify that the foregoing petition for a rehearing of this cause is presented in good faith and not for delay.

MELVIN F. JOHNSON,
Counsel for Petitioner,
Hercules Gasoline Company, Inc.

SUPREME COURT OF THE UNITED STATES.

No. 93.—October Term, 1945.

Hercules Gasoline Company, Inc., Petitioner, *vs.* Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

[December 17, 1945.]

Mr. Justice Black delivered the opinion of the Court.

This case requires us to construe § 26(c)[1] of the undistributed profits tax law, 49 Stat. 1648, enacted by Congress in 1936. The undistributed profits tax, which was not continued by Congress after 1938, was a surtax at graduated rates upon corporate profits not distributed during the tax year by way of dividends. Section 26(c) allowed credits designed to afford relief where the payment of divi-

[1] "Sec. 26. Credits of Corporations:
In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

(c) Contracts Restricting Payment of Dividends.—
(1) Prohibition on payment of dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) Disposition of profits of taxable year.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936.

(3) Double credit not allowed:—If both parargaph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied."

dends is prevented by certain contract provisions. Subdivision (c)(1) of the section allowed such a credit where a distribution of earnings would violate a "*provision of a written contract executed by the corporation . . . which provision expressly deals with the payment of dividends.*" (Italics supplied). Subdivision (c)(2) allowed a credit where earnings and profits of the taxable year . . . [are] . . . required (*by a provision of a written contract executed by the corporation . . .; which provision expressly deals* with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge *of a debt*, or to be irrevocably set aside within the taxable year for the discharge *of a debt.*" (Italics supplied). Petitioner claimed a credit under § 26(c)(1) but in assessing the deficiency for 1937 the Commissioner rejected this claim. The Tax Court sustained the Commissioner and its judgment was affirmed by the Circuit Court of Appeals. 147 F. 2d 972. We granted certiorari because of conflicting determinations by the Circuit Courts as to the scope of these credit provisions.[2]

Petitioner, a Delaware Corporation, admits liability as transferee of the assets of the Hercules Gasoline Company, Inc., a Louisiana Corporation, which was dissolved in 1939. Article V of the original charter of the transferor authorized the issuance of non-par common stock and of preferred stock at $50 par value. The preferred stock was entitled "to cumulative dividends at the rate of 8% per annum . . . in preference and priority to any payment of any dividend on the common stock for such year." The charter further provided that "there shall be no dividend on the common stock until all of the preferred stock has been retired, redeemed and discharged." All certificates of preferred stock contained the following provision: "For Rights and Voting Powers of Preferred Stock See Article V of Charter." The petitioner contends that these preferred stock certificates constituted contracts executed by the corporation which expressly prohibited the payment of dividends while these shares were outstanding and that petitioner is therefore entitled to the credit allowed under Subdivision (c)(1).

We think that the preferred stock certificates are not the kind of contracts which entitle a corporation to allowance of credit under Subdivision (c)(1). In our view that Subdivision must be read

[2] Lehigh Structural Steel Co. v. Commissioner, 127 F. 2d 67; Philadelphia Record Co. v. Commissioner, 145 F. 2d 612.

in the light of § 26(c) and the Act as a whole, and when thus read, is confined to contracts made with creditors and does not extend to restrictions imposed within the body corporate. In *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, the question before us was whether § 26(c)(1) allows a credit where the payment of dividends is prohibited by statute. In construing § 26(c), we stated:

"That the language used in § 26(c)(1) does not authorize a credit for statutorily prohibited dividends is further supported by a consideration of § 26(c)(2). By this section, a credit is allowed to corporations contractually obligated to set earnings aside for the payment of debts. That this section referred *to routine contracts dealing with ordinary debts and not to statutory obligations is obvious*—yet the words used to indicate that the section had reference only to a 'written contract executed by the corporation' are identical with those used in § 26(c)(1). *There is no reason to believe that Congress intended that a broader meaning be attached to these words as used in § 26 (c)(1) than attached to them under the necessary limitations of 26(c)(2).*" 311 U. S. 46, at 49-50. (Italics suplied).

We thus held that § 26(c)(1) is limited to contracts involving ordinary obligations to creditors and since preferred stockholders are not creditors, *Warren* v. *King*, 108 U. S. 389, 399, § 26(c)(1) does not apply here.

Petitioner contends, however, that our construction of § 26(c)(1) was erroneous but for reasons given in the *Northwest Steel* case we think it was correct and adhere to it. Our construction finds further support in § 26(c)(3) which, in order to prevent "Double credit", provides that in the event both Subdivisions (c)(1) and (c)(2) apply, "the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied." Congress having thus made the relief obtainable under (c)(1) and (c)(2) mutually exclusive has indicated that it considered the two subdivisions as interdependent. Congress therefore intended to cover the same type of contract, namely a contract with creditors, in both subsections and not to extend subdivision (c)(1) to intra-corporate contracts while subdivision (c)(2) was to cover contracts with creditors only. Moreover statements made in the course of the Congressional debate[3] refer to § 26(c) as a

[3] See for illustration the statement by the Hon. Samuel B. Hill, 80 Cong. Rec. 6004.

whole, as providing for the relief of corporations prevented from paying dividends by contracts involving the payment of debts. No other view of the Section would be in keeping with the policy behind the undistributed profits tax. That tax was designed to reach profits held by the corporation which as a consequence could not be taxed as dividends in the hands of stockholders. An intra-corporate agreement is simply one way of keeping profits in the corporation's treasury so that the tax collector cannot reach them.[4] To hold that such an agreement entitled the corporation to tax credit would defeat the very purpose of the undistributed profits tax.[5] The rejection of petitioner's claim for tax credit was proper.

Affirmed.

Mr. Justice BURTON dissents.

Mr. Justice JACKSON took no part in the consideration or decision of this case.

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[4] See Warren Telephone Co. v. Commissioner, 128 F. 2d 503, 506. Here there was nothing in the agreement that absolutely prohibited the payment of dividends. During 1937 and 1938 transferor had outstanding 1,294 shares of preferred stock of a total par value of $64,700. Those shares were all retired in 1939. Had they been redeemed in 1937 there would have been nothing in the agreement preventing the distribution of earnings. Consequently it does not clearly appear that there was any provision in the agreements absolutely prohibiting the payment of dividends. Cf. Dr. Pepper Bottling Co. v. Commissioner, 45 B. T. A. 540; Staley Manufacturing Co. v. Commissioner, 46 B. T. A. 199, 205.

[5] The Board of Tax Appeals and later the Tax Court have consistently held that § 26(c)(1) does not cover the type of agreement here involved. Thibaut D. Walker Co. v. Commissioner, 42 B. T. A. 29; Eljer Co. v. Commissioner, decided Dec. 4, 1941, 1941 P-H B. T. A. Memorandum Decisions, Par. 41,533; Budd International Corp. v. Commissioner, 45 B. T. A. 737; Bishop D. Babcock Manufacturing Co. v. Commissioner, 45 B. T. A. 776; Philadelphia Record v. Commissioner, decided January 23, 1943, 1943 P-H T. C. Memorandum Decisions, Par. 43,038.

Mr. Justice REED, dissenting.

Accepting *Helvering v. Northwest Steel Mills*, 311 U. S. 46, completely, I am unable to agree that this contract with preferred stockholders was other than a "routine contract dealing with ordinary debts." Certainly this is not an instance of a "statutory obligation," which are the words used in the *Northwest* case to describe the antithesis of the contract covered. "Routine" and "ordinary," as used in *Northwest*, do not imply to me anything more than an express contract, executed in accordance with Section 26(c)(1).

The exemption provisions of Section 26(c) make no exceptions because the debt of the corporation is owned by a stockholder. If such an exception is to be deduced from the purpose behind the words of the section, it should not be applied to such preferred stockholders as these because their interest is like that of a creditor. As I believe the statutory requirements are met, I should reverse.[1]

The CHIEF JUSTICE joins in this dissent.

[1] See in accord, Lehigh Structural Steel Co. v. Commissioner, 127 F. 2d 67; Budd International Corp. v. Commissioner, 143 F. 2d 784; Philadelphia Record Co. v. Commissioner, 145 F. 2d 613; Rex-Hanover Mills Co. v. United States, 53 F. Supp. 235. See Elger Co. v. Commissioner, 134 F. 2d 251, 255.